Stand by for an e-mortgage boom

How online home loans will change the shape of the market

How will e-commerce change the way consumers choose a home loan? According to AMANDA HEYWORTH, the Internet will become an important channel for originating mortgages — a development with important strategic implications for lenders.

AMANDA HEYWORTH is a consultant specialising in marketing and strategy issues. This article is based on a study undertaken by the author and Cecile Fresneau in 1999 with the support of the Australian Graduate School of Management.

Using the Internet to research and buy residential mortgages is in its infancy in Australia. In the past two years, mortgage lenders have provided product information, loan calculators and online applications on their websites. Online mortgage sites, such as eloan and eChoice, which refer leads to lenders, have also emerged. An increasing number of technology-literate consumers are using the Internet to research mortgage products. However, most lenders admit they have been less than successful in converting leads into settled loans.

But while loan volumes are currently small, US trends suggest that the Internet will become a major channel over the next five years.

In the US, the low interest rate environment in 1998 and 1999 saw a refinancing boom which fuelled the development of the online mortgage channel. Internet loan volumes grew fivefold to more than $US4 billion in 1998 and there are now more than 3,000 mortgage-related sites. Looking ahead, it is difficult to predict the likely growth path for such a new and dynamic market. However, analysts are generally projecting spectacular growth as shown in Figure 1. If fulfilled, these projections would mean that between 10% and 20% of all US mortgages will be originated over the Internet in 2003.

There are some differences between the US and Australia which suggest that uptake will be somewhat slower in Australia. First, e-commerce adoption is ahead in the US for reasons including longer Internet experience, lower Internet access costs, higher bandwidth and a tradition of mail-order purchasing. In addition, differences in the mortgage industry structure mean that the economics of establishing an Internet channel are more favourable in the US.

US mortgage sites potentially benefit from greater scale: US originations totalled $1.5 trillion in 1998 compared to less than $100 billion in Australia. US online sites also have greater scope to disintermediate traditional mortgage brokers, which handle around 70% of US mortgages compared with less than 15% in Australia.

In short, analyst predictions vary widely and Australia is likely to lag the US. Nonetheless, there is reason to believe that the Internet will become an important channel for originating mortgages in Australia over the next five years. At least in part, this is because the Internet delivers considerable benefits to those consumers able to use it effectively.

RAISING CONSUMER BARGAINING POWER

The Internet is having a major impact on consumer bargaining power by providing access to information and by reducing search and switching costs. Regardless of whether borrowers apply over the Internet or in a face-to-face interview, they can use the Internet to arm themselves with more information and borrowing alternatives. According to Forrester Research, the Internet is resulting in consumers who are more price-sensitive, less loyal and more inclined to view products as commodities.

This increased bargaining power will accrue most directly to those borrowers who are connected to the Internet and can use it effectively. As with any new technology, consumer adoption of the Internet channel is not uniform. Figure 3 shows a likely adoption path for the Internet.

The first stage of Internet adoption, information search, is now commonplace in Australia — although some customers become confused and give up quickly. Some "early adopters" have moved to the

FIGURE 1 How fast will US online mortgage originations grow?

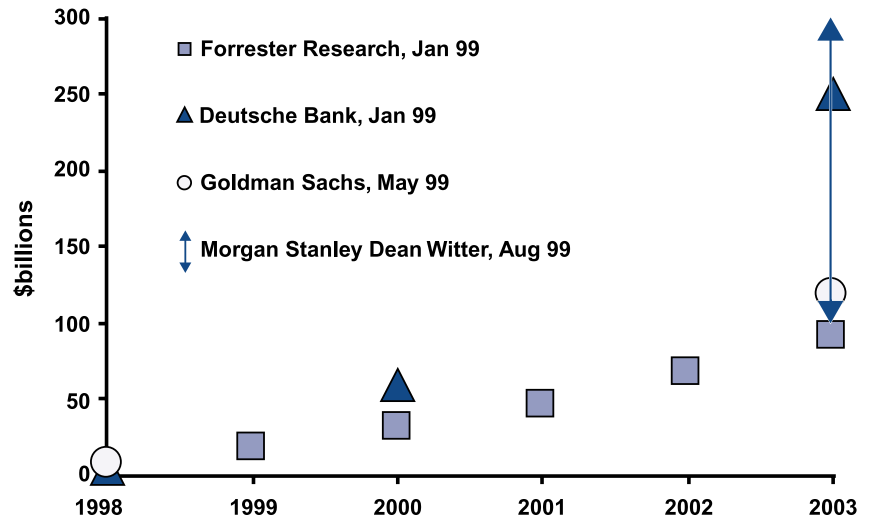


FIGURE 2 How will the Internet change the way consumers use credit?

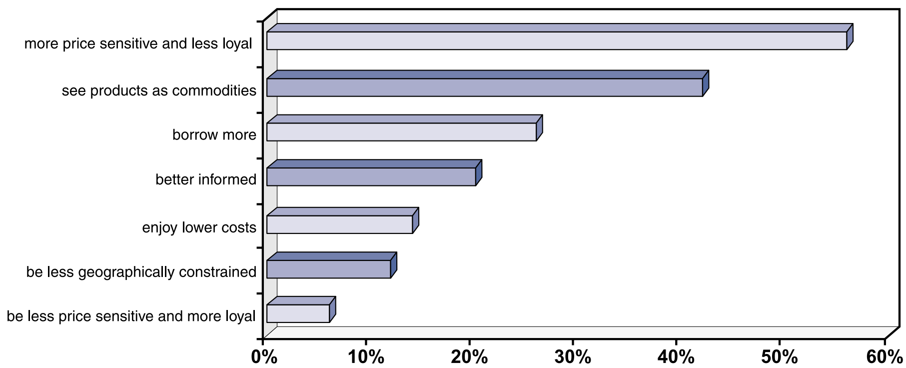
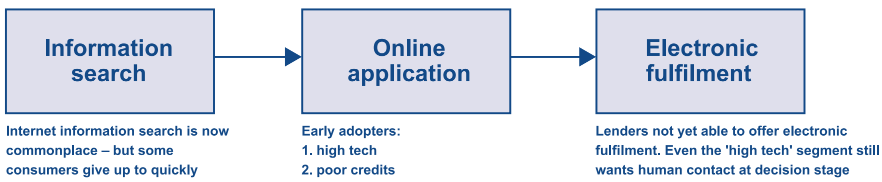


FIGURE 3 How will the Internet channel be adopted?



second stage of Internet adoption: making online applications. At this stage, these early adopters fall into two groups. The first group are experienced borrowers with high incomes who are time-poor. The second group comprises individuals with blemished credit records who are using the web to search anonymously for loans without risking a face-to-face rejection. Lenders will obviously wish to handle applications from these groups differently. However, these segments may prove to be transitory as the profile of Internet applicants broadens over time.

The final stage step in the development of the online mortgage market is complete electronic fulfilment of a settled mortgage. Electronic fulfilment would involve a wholly automated process with risk-based pricing, instant verification of borrower and property information, electronic documentation and recognition of electronic signatures.

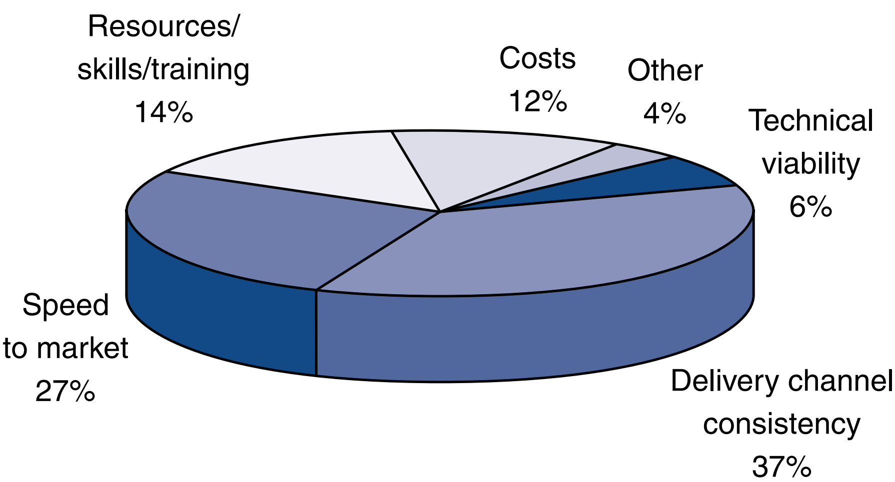
There are myriad reasons why this has not yet been attempted in Australia, including the fact that most lenders have legacy systems which are simply not up to the challenge. According to a global Ernst & Young survey, financial institutions cite difficulties in integrating back-office systems as their biggest organisational challenge in implementing e-commerce (Figure 4). In addition, electronic fulfilment will require regulatory amendments to the Uniform Consumer Credit Code. Given that the code took nearly 20 years to negotiate, reaching agreement on amendments to facilitate e-commerce is not a trivial task.

There is also some question about the extent of consumer demand for electronic fulfilment at this point. Even "high tech" consumers willing to make Internet loan applications may still prefer human contact at the decision and settlement stages of the lending process.

While it may sound like science fiction, lenders will be well served by working towards electronic fulfilment as their ultimate goal. This is because electronic fulfilment implies a seamless integration of information systems and management processes which delivers high-quality service to consumers. The Internet has the potential to raise service standards and reduce costs only where it is integrated with management processes and combined with other technologies such as electronic document management, data warehouses and expert systems.

This back-office integration is considerably more important than having a magnificent website with inspired graphics, navigation and content. A customer survey conducted by the author and Cecile Fresneau in 1999 found that potential borrowers placed a very low weight on their actual website experience when choosing between lenders. As in the offline world, most consumers initially focused on product price (interest

FIGURE 4 **What are the organisational barriers to e-commerce?**



rate and fees) and features (for example, repayment flexibility and redraw facilities). As the borrowing process unfolded, advice and service became decisive factors. Consumers assessed advice and service quality on the basis of their rapport with lending staff and the ease with which their loan was approved. Clearly, effective back-office systems are the key to ensuring staff are well informed and loan approvals are quick and simple.

> ***Consumers assessed advice and service quality on the basis of their rapport with lending staff and the ease with which their loan was approved.***

HOW THE INTERNET CHANGES THE LENDING VALUE CHAIN

By increasing competitive pressures, the Internet is forcing market participants to review their operations and concentrate on activities where they have a competitive advantage. In this sense, the Internet is simply the latest in a long line of developments which have boosted competition in the financial sector.

Figure 5 shows how Internet-based competition is altering the way that different industry participants contribute to the lending process by reinforcing existing trends to greater use of outsourcing and process automation.

These trends present both a threat and opportunity for different types of lenders.

They threaten generalists such as traditional mortgage brokers and smaller lenders who will find it increasingly difficult to compete against technology-driven rivals able to provide superior customer value or cost-efficiency. These institutions will struggle unless they can identify and service niche customer segments which place a higher value on personal service and advice.

The Internet presents an opportunity for those lenders able to form successful alliances with online brokers. Online brokers potentially allow lenders to reach new customers and convert origination to a lower, variable cost. That said, where the online broker takes an ongoing customer management role, lenders will find it more difficult to “own the customer”.

The Internet may also present an opportunity for a small number of lenders to build home loan portal sites which consumers use as their starting point when initiating a search for information about home buying and borrowing. To date, no Australian site could genuinely claim to be a home loan portal. Nor is it certain that any will emerge — it is possible that lenders will be relegated to service providers reliant on the broadbased portals such as ninemsn and Yahoo.

There are major payoffs for a site which achieves portal status in terms of both economies of scale and market power. Portals will have a head start in influencing home loan decisions.

Like the potential payoff, the risk of pursing a portal strategy are also large since it requires a major investment in site development and marketing with no guarantee of success. In the dynamic Internet world, lenders will need strategic flexibility and deep pockets to grow a site to portal status. New entrants unimpeded by legacy systems and channel conflicts will be best placed to build portals, provided they have access to patient capital.

IMPLICATIONS FOR LENDERS

Overall, the development of the Internet channel for home loans will result in a

FIGURE 5 **How is the Internet changing the lending process?**

more competitive market with more demanding consumers.

It is questionable whether website technology in itself will be sufficient to provide lenders with a sustainable competitive advantage. Rather, it is the integration of website and loan approval processes which will be increasingly vital. Good back-office systems are a necessary (though not sufficient) condition for success. For this reason, lenders should aim to integrate their systems and processes in ways which will ultimately provide the "seamless service" implied by electronic fulfilment. The key success factors in online mortgage lending will prove to be the same as those applying to e-commerce markets more generally. Lenders will need to ensure product pricing and features are competitive, develop a strong Web brand to attract volume, invest in technology and manage channel conflict. Beyond these fundamentals, lenders will need to adopt different strategies in the online mortgage market depending on their size, goals and competitive positions. For example:

- Major lenders will need to pay attention to defending their market share through a range of initiatives including cross-selling and electronic fulfilment.
- Smaller lenders and originators with limited technology budgets and scale may need to focus on particular channels or customer segments. They will struggle unless they can identify and service niche customer segments which place a higher value on personal service and advice.
- Nimble new entrants with deep pockets will be best placed to build home loan portal sites.

At the same time, there is considerable uncertainty about how the online mortgage market will develop, so lenders need to monitor trends closely and be ready to adapt their approaches as the market evolves.

After all, Bill Gates originally thought the Internet would never amount to much. J