

The bank that financed my first home vowed *never* to outsource “core” operations. And the bank considered everything “core”. In 1980, there was an appraiser on staff. A clerk called to verify my salary. My loan was held in portfolio – there was no secondary market. Even mortgage insurance was in-house. In a whisper, my banker recommended life insurance since I was buying in the dangerous “inner city”. I told him I was 21, single and reckless, and that HE should buy my life insurance. The bank did buy my life insurance.

Today, 25 years later, lenders continue to assert that they will never outsource “core” or “strategic” operations. This is misleading. Lenders don’t even find borrowers by themselves anymore. Over 68% of loans are acquired via wholesale and correspondent channels, not their high visibility branch networks. Some day, the top lenders may handle just three processes: loan origination, loan servicing on the Fiserv or Fidelity platform and interest rate hedging.

Mortgage insurance, title, servicing platforms, credit reports, scoring, appraisals, LOS platforms and loan registry are the beneficiaries of this shift. These well established sectors profit from outsourcing of formerly core lending *services* now delivered as *products*.

#### **The Offshore Vendor/Lender Mismatch**

There are three hurdles to selling mission critical outsourcing services delivered from India.

First, all the due diligence in the world can’t reassure a US lender of 100% uptime by your operations center in Veriveribad, India. Six Sigma notwithstanding, no business process outsourcing (BPO) vendor is “good enough” for a lender. Further, the burdens of interminable bank due diligence can sap the life of all but the biggest vendor and drive a salesperson to despair. Most senior bank staff do not really want to go to Indianapolis for a site visit, never mind India.

Second, BPO pricing practices try to slough off expense risk on lenders. BPO vendors bill head count by the hour or by the seat. This is incompatible with how lenders tally costs in *their* business. Lenders worry about yield spread and cost per loan. Seat and hourly pricing *adds* to lender risk. Lenders live to shed risk. The pricing model for today’s BPO offerings is wrong. Even worse are the substantial start up and fixed monthly fees that are invariant with a lender’s loan production volume. Charge lenders a fixed price per loan for a task and they might buy a million units. Consider credit reports. Unit pricing drives that thriving business. Data is sold by the drink, not the barrel.

Third, lenders want a choice of at least two vendors. And they prefer low switching costs. Conversely, BPO vendors salivate at the prospect of the closed deal...and a trapped lender. BPO has a long setup time and divorcing your BPO vendor is protracted and

painful. Vendor dependence makes lenders nervous, and delays agreements. For example, the loan servicing platform is a dependency. Thus, that sales cycle takes years.

#### **Product Country of Origin? Who Cares?**

Would you ever outsource any financial process to the Philippines? I wouldn’t. But every year, I spend \$200,000 a year on deed and tax data - all “keyed” in Manila. I would not directly engage an offshore provider to key this data, but my vendor delivers his “services” (compiling, keying, cleansing data) as a “product”. Like a pair of sneakers, I don’t care where it is “manufactured” as long as it comes packaged right. Once data was delivered on tapes. Now it comes from an FTP site behind an IP address. The server might be in Manila (I never “pinged” it to check). The secret is that I get a tangible product (not a service) and I pay a fixed price per record that I can link to my revenues.

#### **Premium Pricing for Assumption of Risk**

Credit reports are another good example. Equifax, TransUnion and Experian will sell you a credit report for a few dollars if you buy a lot of them. These bureaus bear almost all of the capacity risk whether a lender buys one or a million reports next year. They generate billions in revenue on low priced products. They deliver a credit compilation *service* as a *product*. This pricing and packaging are compatible with how lenders operate. Lenders always believe that the next rate induced mortgage slump is right around the corner. To manage that risk, they will pay a premium to avoid multi-year volume commitments. Lenders will also pay a premium to avoid onerous technology integration and tech investments. Lenders will pay a premium to mitigate operational risk, and they will pay more to mitigate market risk, hence hedging operations.

#### **Dissecting Origination & Servicing**

You can break origination and servicing into forty discrete processes. Success at productizing BPO is a matter of picking four or five winners from among these processes. The winning processes will be able to connect into most lenders with just two or three “plugs”. The processes might be labor intensive – they should be offshorable where a college grad costs \$3,000 per year. Processes need to be standardized, with finite outcomes. Processes needs to be stable, with little change over time. Process costs must be able to drop by 50% through re-engineering, offshoring and volume efficiencies. Regulators and rating agencies need to support productization, and the secondary market (an innovation that stifles innovation in retention) must not get in the way. Only a few processes fit these criterion. The benefits to vendors are shortened due diligence, premium pricing and growth. Those processes that pass these tests are the focus of our business development efforts to support the delivery of business processes as services. Stay tuned!

*NOTE: Here “BPO” refers to “business process outsourcing”. To lenders, “BPO” means “broker price opinion”*