



Lessons from the Western Mortgage Crisis: Implications for starting and managing mortgage businesses in other countries

Research White Paper

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Introduction

The problem

The collapse of the American mortgage sector and the resulting difficulties have made mortgage companies, and companies planning to launch mortgages, worry about the implications for their own business. The crisis exposed major strategic and operational weaknesses in mortgage lending around the world, and it is important that mortgage businesses understand the lessons being learned.

Purpose

The purpose of this Research White Paper is to explain:

- The strategic weaknesses that caused the crisis, and that made the crisis worse once it began
- The aspects that have become crucial for successful mortgage lending
- How to build and manage a successful mortgage business

Approach

The approach has involved:

- Collation of detailed information about the way that mortgage companies operate, and the ways in which they ran into trouble in recent times, based on a combination of original research and extensive client work across numerous countries
- Identification of key success criteria
- Utilisation of anonymous case studies
- Presentation of actionable insights, offering mortgage companies or start-ups the opportunity to see how the recommendations would apply specifically to an organisation like their own

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Overview: what went wrong in the West, and what lessons can be drawn

When the American crisis happened, mortgage companies in other countries found their own bad practices exposed...

The main media commentary on the global mortgage crisis has focused on the American market, because it was the first, and the largest, market to run into trouble. Although it is important to understand the basic reasons why the American problems occurred, in many ways these were not really related to the issues that then spread around the world. We will therefore touch only briefly on the American crisis, but consider in more detail the ways in which it affected mortgage companies around the world, and the reasons why many of these companies then found themselves in trouble.

The four causes of the American collapse

The American problems were the direct result of an overheated and poorly controlled market. Four dangerous developments came together:

- Consumer desire to make money from a real estate boom, with mortgages as the way to get on a 'get rich quick' escalator
- Lenders' willingness offer larger mortgages to consumers than before, and to expand into 'sub prime' lending to consumers who would never previously have qualified for a mortgage
- The willingness of the capital markets to buy and sell collections of mortgage loans, with no real understanding of their credit-worthiness
- A lack of regulatory control over a booming market in which all parties were making money

The result for the global economy was a crisis triggered by the near-collapse of the capital markets, as they discovered that the securitised bundles of mortgage loans were systematically going bad. In this regard the crisis has little relevance to the strategies and operational practices within mortgage lenders in other countries. However, the real lessons from the crisis have arrived from the secondary effect across the world. As mortgage companies struggled to cope with higher costs of capital and with the effect of consumer recession, their own business models were put under strain. This is because of a series of poor decisions and poor practices that had characterised these

lenders during the previous years. Some of these were borrowed from the American market, and some were quite separate mistakes made by lenders in other countries.

Mistakes copied from the American market

The main characteristic of the American market was the belief that the economy was going to continue growing. With housing prices continuing to rise, and unemployment levels remaining low, lenders felt comfortable taking risks. The dominant feeling in the mortgage sector was that, even if profit margins began to fall and impairment rates on sub-prime business started to rise, these would be compensated for (and more) by the record levels of sales.

Strategic flaws in British mortgage market

The world's second largest mortgage market, Great Britain, had followed a very similar course in the years leading up to the crisis. In common with the American market, there were weaknesses in both strategy and operational practices:

- Over-optimistic view of continuing economic stability and market growth
- Lack of proper scenario-planning and stress-testing, leaving lenders with no alternative plan when the economy deteriorated
- Corporate focus on record sales growth, in the belief that this would create record profit
- Inadequate credit risk practices, based on automated decisioning and poor understanding of consumer behaviour

Later sections of this paper detail these operational mistakes, and others that have emerged in the UK and other markets, and consider what should have been done differently and what will be essential for future mortgage success. In many regards, however, these operational failures happened as the result of a poorly-considered growth strategy by mortgage companies in numerous countries.

Case Study: the importance of correct strategic planning

The UK mortgage market serves as an example of what happens when an overall strategy is misguided. The dominant characteristic of the British market in the period 2000-2007 was growth. Share prices were largely linked to market share, and management rewarded for successive years of record sales volumes.

Loss of control

However, in the rush for growth a number of areas of vital control were sacrificed: control over the customer relationship (which was increasingly given to intermediaries); control over lending quality (in which Risk departments felt themselves under increasing pressure from Sales and Marketing departments to take