

# Renewing Home Equity Lending

BY ANNETTA CORTEZ

Home equity lending has been a mainstay of retail banking, delivering superior levels of growth and profitability while providing a solid anchor for customer relationships. The market has radically changed following the wrenching U.S. recession, however, and banks will need new strategies and skills to make their way over the next few years.

At a time when the annualized pace of home equity loan origination is down roughly 70% from the 2005 peak, it is clear that lenders will be competing fiercely over a shrunken pool of borrowers who: 1) still can qualify for this type of credit, given all the issues with jobs, housing values and household indebtedness; and 2) still have an appetite for borrowing, given the fragile confidence in the economy and in banks themselves.

In many cases, the front line of this battle will be found in the branch, where live representatives are generating up to three-fourths of all new home equity credit at some major regional banks. As opposed to frenetic order-taking at the top of the market, reps now must play a prominent consultative role, not only to more thoroughly prepare and evaluate applications, but also to shore up borrower confidence.

Behind the scenes, banks will need to be much more deliberate about how they acquire and underwrite new business. This includes high sensitivity to local market housing conditions, as well as to the financial solidity of each household applicant. Then within this narrowed bandwidth of feasible lending potential, improved risk-adjusted pricing will be needed to protect the portfolio and provide adequate shareholder returns.

The good news is that there still is an important role for this business. Home equity lending provides a valuable form of consumer credit. It allows households to borrow on attractive terms, for purposes such as home improvement, education financing, and debt consolidation. And this type of borrowing facility is becoming even more important these days as many other sources of credit financing are drying up.

To win share in a sharply constricted market, however, retail banks will have to move beyond the product-push strategies of recent years. The new competitive dynamic hinges on a much more analytical understanding of markets and customers, coupled with a much more consultative and personalized interaction with each borrower.

## PROMISE AND PERIL

Even as they continue to dig out from a historic crisis in mortgage and retail credit, banks still are pinning revenue hopes on home equity lending.

Indeed, if handled correctly, this line of business very well could be the top opportunity for retail loan expansion over next few years.

From the banking perspective, there are three main reasons why this is so. At the most basic level, home equity

lending still offers the potential for high returns, with such accounts fueling three to four times the customer relationship profitability, compared with the retail bank average.

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Second, there still is plenty of latent borrowing capacity in the market. As of early 2010, battered U.S. households were still sitting on top of an estimated \$6.3 trillion of unencumbered home equity. That is a valuable cushion at a time when unsecured credit is generally more costly and difficult proposition for lender and borrower alike.

Finally, most other retail lending avenues are even further in the tank. Demand for whole mortgages continues to contract; the outlook for student and small business lending appears stagnant; and for the very largest banks that have their own credit card portfolios, the near term picture is a morass of shrinking demand, reduced borrower eligibility, new regulatory restrictions, and heavy collections activity.

There’s still a lot of sand in the gears, however. From a balance sheet perspective, many banks remain over-weighted in mortgage credit and face ongoing challenges in clearing up the risk exposure already embedded in their portfolios.

And the market remains heavily impaired. Nearly one fourth of the nation’s homeowners owe more on their dwellings than the current sales value, which wipes out a huge chunk of home equity lending potential right there. Formerly prime growth markets, such as Florida, Nevada, Arizona and Southern California, remain depressed. And millions of people are looking for work, many jolted after years of steady employment.

The banking situation combined with the market and household financial situation, creates a scenario for selective growth at best. Many medium- or high-risk households that might have been considered workable loan prospects only a few years ago, now are off the radar screen for new credit. Conservative borrowers, meanwhile, didn’t overextend themselves at the top of the market and certainly aren’t going to do so now.

The bottom line is that there will be a much smaller pool of home equity loan prospects, especially over the next few years, and revenue-hungry banks will have to seek out this

business and compete strenuously to win market share.

### SUCCESS FACTORS

Increasingly, the retail branch will be the swing factor in home equity lending. Successful banks will not only build borrower rapport and trust within the branch, but they also will drive sophisticated central analytical abilities at the point of sale, enhancing underwriting, pricing and loan customization far beyond what is usually seen in the field.

Bankers will need to change their stance from “order takers” to relationship managers. Making that transition, and understanding the human factor in loan origination, will be essential in winning market share. In turn, branch representatives will need to play a leadership role in understanding customers and responding to their needs. Combined with specialized expertise, this type of advocacy will be vital in attracting new business, and retaining valuable customers. Households want to secure a home equity loan without having it coming back to bite them. This reinforces the role of the branch representative as an adviser and counselor.

Risk management also needs to improve. Portfolios will need to be managed more proactively, so that the bank does a far better job of detecting emerging situations before they spin out of control. This includes making greater use of stress-testing, an analytical exercise that constantly tests portfolio performance assumptions by considering the potential impact of various trends, developments and possible adverse events in the marketplace. Even when the markets return, many banks probably will stick with more conservative downside estimates to protect themselves.

A companion goal is to improve risk-based pricing. To more thoroughly analyze risk exposure, leaders will move beyond broad market trends to explicitly consider conditions





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in local housing markets, in some cases down to individual zip codes. They will also look more carefully at household financial profiles, to ensure there is equity to borrow against and adequate income for debt service. Ironically, some small players are becoming first movers in this area, even though the larger banks see themselves as more sophisticated.

As the bank does a better job of analyzing potential risk exposure, then it can do a better job of factoring the cost of that exposure into loan pricing. Some major banking companies have recently discovered that a large portion of accounts — sometimes up to half — are not providing a margin that adequately compensates for risk.

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Eventually, we will see that leading lenders also consider market price sensitivity when they set interest rates. This exercise is based on an economic concept called price elasticity of demand. It allows the bank to carefully balance the twin goals of balance growth and margin enhancement.

From a marketing perspective, sensitivity to local housing markets will definitely be a part of the home equity lending equation going forward. There will be fewer shotgun-style marketing campaigns, and a greater number of focused, analytically-guided initiatives that consider both household and housing risk. Under the banner of precision marketing, some banks are working to refine their initiatives to the sub-regional level.

As they look across their geographical footprints, banks will be searching for the best customers at the right prices to support their risk criteria. They will also be searching for expanded opportunities with the customers they know best — those who are already doing business with them.

There are three major types of opportunities with established customers, including: 1) encouraging activation and increased usage of outstanding home equity lines of credit; 2) selling additional banking products to home equity borrowers; and 3) providing home equity credit to customers who are already using other product lines.

To unlock these opportunities, the bank will need to improve its analytical understanding of the current customer portfolio. Among active current users of home equity lines of credit, for example, what patterns and insights can be gleaned that will be of use in encouraging inactive account holders? What are the top cross-sell possibilities, based on knowledge of the total customer relationship? Such research-based explorations are crucial in an era when relationship expansion is the priority.

### **MANAGEMENT PRIORITIES**

In terms of management implications for banks, there is a clear need to strengthen the central analytical capability at many institutions, which formerly may have delegated responsibilities to regional teams or simply never considered the business case for building advanced skills. In the areas of targeted marketing, precision underwriting and risk-adjusted pricing, banks will need far more sophistication than what was viewed as being necessary only a few years ago. A companion challenge is driving this knowledge to the branch

for use in real-time decision-making. With full deference to the need for sensitivity to customers and an authentic relationship context, representatives still need a robust basis for quick, accurate and optimal responses to new loan applications.

While some banks have made great strides in beefing up the “analytical back office” of the branch, many others have serious work ahead of them. A recent multi-bank survey conducted by Novantas, for example, indicated that central pricing teams often are little more than skeleton crews in home equity lending, with enormous portfolios being handled by just a few individuals.

Then in terms of bringing centrally-generated insights to the branch, many banks face coordination challenges, both in terms of management and information.

Retail banks often operate as a collection of separate divisions, with one group managing the branch network; another managing products; another managing analytics, etc.

In this case, the home equity product team will need to build stronger organizational bridges. In other situations, there will be challenges in configuring information systems to supply relevant sales and customer information directly to the branch representative while transactions are in progress.

Finally, to fully capitalize on all the behind-the-scenes preparation, branch representatives will need to step up to a higher level of performance with home equity borrowers and products. The goal is to sharply improve sales effectiveness across a transaction stream that is much smaller than just a few years ago. Training, coaching and sales management will play into this, and in many cases, performance incentives will need to be revisited to encourage balance formation and cross-sell.

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