GSE's and Their Technological Impacts

In the last ten years the mortgage loan industry has witnessed sweeping changes from technology introduced by both Fannie Mae and Freddie Mac. Included in these changes was the introduction of the Automated Underwriting Systems (AUS) in the mid-1990's. While the industry has seen other new technological introductions, none have been as profound as Desktop Underwriter (DU from Fannie Mae) and Loan Prospector (LP from Freddie Mac). The GSE's technological impacts on the mortgage industry are widespread and outlined below.

Lenders Required to Adopt DU and LP

In 2005, most loans purchased by the GSE's will have been underwritten by these AUS's. Each mortgage lender is effectively required by the GSE's to use their respective AUS.

Why Lenders Must use GSE's Automated Underwriting System:	**What the GSE's claim:**
The GSE's provide a monetary incentive for the use of their AUS such as better guarantee fees (g-fees)	Their AUS saves the industry and consumer's time and money.
G-fees have also been increased for those not adopting the use of the AUS's	Non-AUS loans could pose higher risks
Loans ran through their proprietary AUS's can obtain greater legal waivers to prevent a possible loan buy-back requirement against the lender	Their AUS is better at preventing risky loans
No other AUS is approved	No reason to have another commercial AUS
A goal of the GSE's is that 100% of loans purchased come through DU and LP	Better efficiency and consistency in underwriting

Is the Industry More Efficient After the Introduction of DU and LP?

It was with great fanfare that DU and LP were announced under broad statements about industry efficiency and reduced costs. Fannie Mae went so far as to state in a press release some years ago that DU would save the industry $1000 per loan. Independent industry surveys have not seen a reduction in cost per loan since the introduction of these two AUS's. They actually show a general increase in overall loan production costs and costs directly related to underwriting. There could be several reasons that DU and LP have not increased efficiencies for the industry and the consumer:

- There is a charge from the GSE for each loan underwritten by DU and LP
- There are significant user training expenses born by the lender
- DU and LP could inherently be less efficient than manual underwriting
- There are computer related expenses as with all software
- There is an increase in costs for third party vendors to deliver their products through these AUS's since vendors are charged fees by the GSE's.
- The mortgage software companies that support the industry must incur (and pass on) large support expenditures to interface their software with DU and LP

The usage of DU and LP by lenders has simply become a requirement of doing business with the GSE's. Since the GSE's do not allow any other independent AUS, the free market has not allowed the most efficient AUS to prevail. Most in the industry believe that if AUS's competitive to DU and LP were allowed to be developed, they would likely be more efficient and would drive down the cost for the consumer. Prior to the existence of DU and LP there were many automated underwriting systems in the marketplace but these have mostly either become extinct or relegated to loans the GSE's don't handle. While Fannie Mae claims that DU is cutting $1000 from the cost of the loan, the reality is that the dollar savings just aren't there. Still, lenders do see the benefits of AUS's. This is especially true with plain vanilla type loans that can now fly through the loan process allowing underwriters to concentrate on the more difficult loans. In addition, DU and LP are much more lenient allowing more borrowers to qualify.

GSE's Move to Sell and Deliver Third Party Products

With the usage of DU and LP now dominating its marketplace the GSE's have moved on to the delivery of third party products. In the last several years, both Fannie Mae and Freddie Mac have begun to deliver various products through their AUS's. For example, credit reports are routinely ordered through DU and LP earning both GSE's significant additional revenues. Fees from credit reports are just the tip of the iceberg for generating new found profits by Fannie Mae and Freddie Mac. Fees paid to the GSE's come from the service providers in the terms of transaction fees. Eventually, these fees are passed on to the consumer as the service costs are kept artificially high. Below is a list of consumer paid services for which the GSE's could or already are earning transaction fees.

Service	When ordered	Paid by
Appraisal	Required at application	Consumer
Credit Report	Required at application	Consumer
Flood Certificate	Require prior to close	Consumer
Title Insurance	Required at close	Consumer
Broker/Wholesaler Submission	Transaction prior to close	Lender
Automated Property Valuations	At application	Consumer
Automated Underwriting	At application	Lender
Mortgage Insurance	Prior to close	Consumer
Closing Document Preparation	Prior to close	Lender

Since the industry is required to use the AUS's there are no limits as to how much the GSE's could earn when they require these third party services to be purchased through the AUS's. Just like credit reports, the GSE's could require these products to be purchased through the AUS's. Since there is no competition in this entire process, the amount of the transaction fee is boundless. The GSE's could double the price of the credit report if desired with no method to keep such in check. These fees result in higher costs for loan production and ultimately a higher price to the consumer.

GSE's Build Worlds Largest Consumer Repository

Today, the GSE's collect and store more information on the consumer than any other system in the world. The standardized home loan application contains more information about the consumer when compared to any other consumer purchase. To date, the GSE's have primarily used this information to underwrite loans. More recently, this information is being used to help in the automated appraisal arena. They have gathered a rich database that can help predict a market price of homes about to be sold – such information is unavailable to any other firm in such quantity. The fact is that the GSE's are building the richest depository of consumer information that has ever existed. The value of such a database would be greater than the value of all the consumer repository companies that exist today. The GSE's could use such information for a variety of purposes all in the name of "making the loan process more efficient" or to "save the consumer money". Without new regulation, a sample of products that could be marketed by the GSE's are in the following chart.

Type of Service	Description	Paid By
Employment Insurance	Covers household breadwinner in case of disability	Consumer
Homeowners Insurance	Protects lender against hazards such as fire	Consumer
Environmental Reports	Reports on any environmental hazards	Lender or Consumer
Fraud Detection	Check against available fraud databases to help insure no fraud exists on each loan	Lender
MERS Registration	MERS is an industry consortium to help streamline the industry. Fees could be charged for registration.	Lender
Life Insurance	General or that protects the lender in case of head of household death. Could be force-placed by the GSE's.	Consumer
IRS Access	Access to annual income reported to IRS is very valuable to lenders during prequalification of a borrower	Lender
Selling the mailing lists	There are few protections in place and the possibility exists to sell access to this consumer information to thousands of companies (similar to ChoicePoint).	Third parties

Given that the GSE's are exempt from privacy laws, the GSE's could be involved in selling almost any consumer service and durable good. This same information in the hands of the wrong people could also be used for fraudulent purposes and crime. Every piece of information needed for consumer identity theft is in these databases and little is known about any safeguards.

Stifling Innovation

Today, there are many technology areas in the industry that lack investments while other areas see significant competition. The problem streams back to the investors in technology and their risk aversion to the unknown intentions of the GSE's. The GSE's have the ability to either validate a business model or put a startup out of business based upon their policies. The GSE's have done nothing to describe their intentions on what technologies they plan to develop and what areas they'll leave for someone else. When the GSE's introduced automated underwriting systems, we saw many companies stop their own such initiatives. Millions in funding and development were wasted as projects were halted. Had these products been allowed to come to market, the industry would be more productive today. If the GSE's decide to dominate an area, there is nothing other companies can do to impede their progress. The industry is being held back with technological innovation in the following additional areas:

- Paperless Loans – both GSE's recognize the importance of this area for streamlining the industry but neither has defined their position or supported third party development efforts.
- Automated Property Valuations – both GSE's appear to be developing their own solutions even though about a dozen companies already exist. Third parties are unclear of the GSE's direction and the GSE's have not defined any standards.
- Underwriting/Processing Guides – underwriting guidelines are now considered GSE trade secrets when before they were widely published. This reduces the ability of lenders to automate their internal processes to create efficiency.
- Broker to Wholesaler Connectivity – both GSE's have taken some steps to develop this market though they are taking a very slow approach. Existing companies have great solutions but are guarded about their future. While the GSE's have released some solutions in this area they are woefully inadequate and their intensions remain unclear.
- Transaction Gateways – several companies are cautiously building sizeable transaction systems to handle the industry's high volume of vendor orders. Still, the GSE's have consistently developed some of the solutions while leaving others to future development. General direction and seriousness are unclear.
- Additional areas include credit scoring, document image storage, loan product guide distribution, mortgage pricing, loan package delivery, title plant innovation, etc.

How GSE Technology is Hurting the Consumer

Each of the areas above have significant cost issues that show up in overall retail pricing to the consumer. The less efficient the industry is, the more the consumer must pay for the right to obtain a mortgage loan. In addition to the inefficiencies noted above, the consumer remains disadvantaged in yet another more direct way.

Both LP and DU are used at the point of sale by 25,000+ loan officers – the vast majority of time, only one AUS is used by any given mortgage origination company. The reason only one AUS is used is because of DU/LP fees, training, g-fee discounts and GSE contractual obligations. By design of the GSE's, the industry practice is to allow the consumer access to one only one AUS.

However, both GSE's highly tout how their AUS accepts loans that the other GSE's AUS doesn't accept. For most mortgage origination companies, when a borrower is turned down by just one of the AUS's, they consider the borrower a sub-prime candidate which have significantly higher interest rates. However, the consumer is never told that the other GSE may have purchased their loan at conventional lending mortgage rates. The end result is that there are tens of thousands of borrowers that are now paying more each month than they should be. The solution is simple – just allow a single system for one price that will access several AUS's. If open systems were used, every consumer could be ensured they obtained the best possible rate. Technology should not be used to reduce the choice of consumers or to prevent the development of efficient solutions.

Regulatory Recommendations

Prior to the mid-1990's the GSE's did a commendable job securitizing mortgages for sale to Wall Street. Since the introduction of the AUS's and other GSE technologies, the industry has become less efficient and highly controlled. Regulatory relief would allow the free enterprise to thrive once again in the mortgage technology arena. To accomplish this, certain specific areas should be addressed:

1. GSE's should be limited to developing technology specific only to streamlining the delivery of loans to the GSE's (loan delivery and reporting).
2. All underwriting rules should be widely distributed as they were prior to the mid-90's. This includes opening up the rules within DU and LP (open source the rules). Both DU and LP should be phased-out over three years.
3. GSE's should not be involved in the handling and selling of third party services including appraisals, title insurance, mortgage insurance, flood certifications, credit reports, mortgage broker/wholesaler systems, closing documents and automated property valuations.
4. No consumer information should be gathered other than that specifically required for delivery of mortgage loans in the secondary market. The GSE's must be prohibited from using consumer information for any activity outside of the delivery of loans.
5. The GSE's should not be allowed to earn fees beyond their traditional g-fee income and should be specifically excluded from charging for use of any technology.
6. The GSE's should use best efforts to support the industry in setting standards to help private enterprise streamline the industry.
7. The GSE's should use best efforts to allow lenders and mortgage originators to access multiple AUS engines (including DU & LP) to better benefit the consumer.

8. The GSE's should be prevented from developing technology solutions used at the point of sale or directly by consumers.

Scott Cooley developed the first loan production system in 1982 and has been involved with virtually every major mortgage technological innovation. Today he consults for a wide range of mortgage technology firms, writes for major mortgage publications and speaks at the major conventions. See www.scooley.com for more details about Scott and additional writings about GSE technology. *4/20/05*