

The **GSE** REPORT™

Special Supplement

Erecting Tollbooths on the Information Superhighway

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Erecting Tollbooths on the Information Superhighway

The U.S. mortgage market has flourished for the past sixty years as a result of a partnership between taxpayers, the private lending industry, and professionals who competitively provide specialized services to the industry:

- Represented by the federal government, taxpayers chartered government sponsored enterprises (GSEs), gave these companies the mandate to enhance mortgage market liquidity, and provided subsidies to help the GSEs fulfill this mission;
- Lenders worked with the GSEs to establish consistent terms and conditions for the loans the GSEs purchase, so consumers everywhere in the country had standardized loans available;
- Specialists brought competitive sources for credit enhancement, insurance and valuation to the market, providing assurances that loans purchased in the secondary market met recognized quality benchmarks, regardless of who the consumer was and what type of home he owned.

By working together, these partners gave consumers the ability to purchase homes with affordable down payments and obtain reliable financing. However, that is the past. Today, the partnership balance is under assault by growth-minded GSEs who are exerting their size, subsidies and monopoly power on their partners to gain more profits for themselves. Lenders and mortgage insurers have first-hand knowledge that GSE expansion plans mean they lose market share. Soon, appraisers and title companies will understand that they are targets, too.

Fannie Mae and Freddie Mac are so confident they have a winning strategy to take over these markets that they are straining relationships with their partners and sacrificing the balance that has created a mortgage market envied by the rest of the world. If they are right, private companies that have productively served the industry for decades will be driven out of business, unable to compete with a government-subsidized shared-monopoly. If they are wrong, taxpayers and industry partners will have to pick up the pieces and rebuild what GSE ambitions have destroyed.

Growth Hormones for the GSE Giants

Last year, Fannie Mae and Freddie Mac, the two largest GSEs, announced their intentions to double their profits in five years. That means their combined 1998 income of over \$5 billion will rise to more than \$10 billion – an annualized growth rate of 15 percent. The residential mortgage market that they were chartered to serve is growing by 7 percent a year, so these targets mean that the GSEs will not be conducting “business as usual.” Such aggressive goals will be met by moving into new markets.

Increasingly, future GSE profits will come from markets opened by riding the information superhighway. Fannie Mae and Freddie Mac are using the Internet to redefine their relationships with their partners. They are creating bridge for direct contact with realtors and consumers. Technology has made this possible. In the days before automated underwriting (AU), a lender completed an underwriting review of borrower’s information before that

consumer knew what size loan he could qualify for. Now, the necessary information is entered into a computer model, and the consumer has an answer in the minutes it takes the AU model to access credit data and “run the numbers,” then deliver an answer across broadband transmissions. Fannie Mae and Freddie Mac share a monopoly position in AU, and they are using their precedent-shattering early participation in the loan process to open new business opportunities. Through GSE AU, they become the first mortgage partner to reach the consumer, determine what that consumer needs, and sell GSE-networked products and services.

“Subsidy Power” Explodes 1999 Profits – But It Will Lose Its Punch

Fannie Mae and Freddie Mac far exceeded their 1999-profit growth target by expanding use of their federal debt subsidy. Together, they sold over \$110 billion of GSE debt to investors who believe that GSE debt carries an implied federal guarantee that makes it nearly as risk-free as U.S. Treasury notes. Fannie Mae and Freddie Mac invested this money in mortgages that lock in steady stream of profits for the coming years. Steady, stable profits from a growing investment portfolio give them a big push toward reaching their five-year profit goal.

However, investment portfolio expansion, even when it’s backed by an implied federal guarantee, has its limits. The two-company shared monopoly that controls the mortgage secondary market now has the largest concentration of residential mortgage debt in the country. As former OFHEO Acting Director Kinsey pointed out in May 1999, the \$725 billion-plus combined retained portfolio of mortgage assets at Freddie Mac and Fannie Mae exceeds, by well over \$100 billion, the combined holdings of mortgage assets by the entire thrift industry. According to the American Enterprise Institute, Fannie Mae and Freddie Mac already own more than 75% of all conventional/conforming mortgages. If they met their growth targets solely through residential mortgage purchases, they would own a 92% market share in 2003. Such a concentrated market share would mean that few other investors are interested in owning high-quality assets like conforming mortgages – and that’s unlikely.

Even if Fannie Mae and Freddie Mac could buy enough mortgages to reach a 92% market share in 2003, their future mortgage purchases may not have the profit potential that the past ones did. The interest spread on future assets will shrink due to pressure from both increasing asset prices and a rising cost of funds. Since the GSEs will find themselves bidding against other investors who want to own mortgages, the prices they pay will go up. The January 3 article quotes one bond dealer, who asserts, “There’s no doubt that corporate spreads have been pushed out because the agencies have increased the overall supply.” The aggressively expanding supply of GSE debt is raising interest costs for all issuers, including the federal government, and crowding out other debt. *Investment Deal Digest* already sees the spreads on debt securities rising due to the large supply of GSE debt. The Bond Market Association attributes 1999’s drop in foreign investors’ purchases of Treasury securities to the growing supply of agency/GSE issues. This year, Fannie Mae and Freddie Mac debt issuances are projected to jump another 10% over the record levels of 1999. By using their implied federal guarantee of debt to the point of creating oversupply, the GSEs will find that the spread they earn on their mortgage investments will fall.

The GSEs Will Turn On Their Partners and Move into Complementary Markets

“Mission creep” – using government subsidies and secondary market dominance to move beyond their government mandate to provide liquidity to the mortgage market – does not face the same growth barriers that subsidy expansion is approaching. Events of 1998 and 1999 provide abundant examples of mission creep into new areas of mortgage lending – such as home equity, subprime, construction, and luxury apartment buildings – and new lines of business, such as mortgage insurance. The essential catalyst to many new lines of business is the GSEs’ monopoly hold on automated underwriting (AU). They have a 95% share of the AU market. The fact that they are requiring GSE AU for more and more special GSE products freezes out potential competitors. However, their greatest monopoly control comes from the proliferation of GSE AU through the Internet that can be used to tie automated approvals to other products and services introduced to consumers before they even talk to lenders. Fannie Mae and Freddie Mac have established partnerships with Internet gateways, broker exchanges and even on-line auction houses. The GSEs provide the underwriting software and the partners provide the direct borrower access. Online approved mortgages are parceled out to a network of lenders who have agreed to close the loans in conformance with the online GSE AU approval.

The GSEs justify mission creep by invoking their commitment to encouraging more Americans to become homeowners. On January 14, 2000, Fannie Mae announced the “Mortgage Consumer Bill of Rights,” centered on the seemingly altruistic goal of advancing consumer protections and extending affordable mortgages to more homeowners. After years of denying its interest in subprime lending and other businesses, Fannie Mae is openly announcing its intention to enter every business it can – all in the name of what the company says is “best for the consumer.” This is a “win/win” strategy for the GSEs. They leverage their federal subsidies and monopoly market share to muscle into new markets by tying new products with their established secondary market “brand name” presence and AU services. One likely target will be to skim from the fees of the competitive professionals that provide a service or product that is a necessary part of getting mortgages – credit agencies, mortgage insurers, appraisers, closing attorneys, and title companies. The GSE AU monopoly gives Fannie Mae and Freddie Mac the opportunity to create massive databases that will open new lines of business for them. GSE AU is compiling all the credit and real estate information used to underwrite, close and service a loan. Fannie Mae and Freddie Mac will soon own information that will allow them to “cut out the middleman” and provide the services themselves, or to force price reductions for limited appraisals, title work, and other professional services. When GSE AU is involved in the loan process from the beginning, it can recommend GSE products in lieu of other competitive products, and offer incentives that favor the GSEs by making price concessions on other products/services or by waiving certain lender representations and warranties. Mortgage insurers already know that the GSEs want to dominate their business, and GSE AU is helping Fannie Mae and Freddie Mac win market share. Other specialists ignore this lesson at their own peril.

The three attached mortgage process flow charts show how AU is transforming the mortgage business. Traditional pre-AU mortgage loan approvals required early interaction with an Underwriter who was trained to evaluate credit risk and understood the secondary market requirements for mortgage loans. After a Loan Officer took the application, the data was sent to an Underwriter for approval, and the Consumer waited to hear the Underwriter’s answer. Once a loan was approved, the data was turned over to a Loan Processor who had the responsibility of

collecting remaining data, ordering an appraisal, and preparing the loan for closing. AU has simplified and shortened the approval process by using a computer to approve loan applications that fall within standard guidelines, getting an Underwriter involved only when the application does not meet these standards. GSE AU differs from a competitive AU market because Fannie Mae and Freddie Mac are capturing all of the data collected during a loan approval/closing for their exclusive use and benefit, and are tying GSE au use to other GSE products.

New GSE fee opportunities deriving from GSE AU are shown in green on the following charts; the loss to independent real estate professionals is shown in red. Appraisers, title companies and other competitive real estate professionals who want to stay in the business will have no choice but to comply with the GSE way of doing business – manipulating data provided by the GSEs, lowering service, and accepting reduced fees. Dissenters will be cut out of the GSE referral network and put out of business.

For the Greatest Consumer Benefit, Encourage Competition!

While they extol the benefits of GSE AU, Fannie Mae and Freddie Mac will not tell consumers that they will see the same administrative and processing cost savings in a competitive AU market. Fannie Mae and Freddie Mac have the public relations machines to argue AU savings come from having the GSEs to set the rules and agenda for the mortgage industry. However, a monopoly AU market has costs:

The GSE Automated Underwriting (AU) Mortgage Market Monopoly: Benefits and Costs

	Benefit	Cost
Allow AU to collect and coordinate data and workflow, then automate administrative tasks	Saves time and cuts administrative costs*	<i>Non-competitive</i> AU systems controlled by a shared-monopoly will result in fewer choices, and ultimately, higher prices
Use AU compiled databases for research/evaluation services now provided by appraisers, title companies, and other competitive professionals	Shortens loan processing timeframe*	Eliminates competitive checkpoints that have traditionally confirmed the value and validity of collateral

*These are not exclusive to GSE AU; competitive AU has similar benefits

If competition is encouraged in all segments of the mortgage market, including AU, consumers can enjoy cost savings with greater product choices made available to them.

Left unchecked, the GSEs’ “mission creep” and growing power from their shared monopoly of automated mortgage underwriting will drive the United States to a nationalized mortgage industry, with “order taker” lenders closing loans that they sell immediately to Fannie Mae and Freddie Mac. The GSEs will set standards and prices for the industry, and the competitive checkpoints that have assured the collateral integrity of mortgage lending will be shaved back in the name of protecting mortgage consumers.

The Traditional Conforming Mortgage Loan Process

	Application	Approval	Documentation	Closing	Servicing
Consumer	Makes application to lender; pays fees for credit report and appraisal		Provides missing data for loan application and credit report; selects closing attorney	Signs documents at closing; approves fee payments to lender and title company, title insurer, and mortgage insurer	Makes loan payments
Lender/ Servicer	Loan Officer/ Broker takes application	Underwriter approves loan, subject to any missing data and verifications, following review of credit report adequate appraisal value	Loan Processor obtains missing data and orders appraisal, recommends closing attorney to Consumer	Loan Officer confirms that all underwriting requirements are met, authorizes funding and collects origination fee	Servicer collects loan payments and monitors payment status in return for a servicing fee negotiated with GSE; sends P&I payments to Lender
GSE		Sets underwriting standards and program guidelines for loan purchases, which are subject to Lender reps and warranties	Sets documentation standards for different programs	Purchases closed loan, then packages and sells it in the secondary market	Collects GSE/Investor loan guarantee fee; sets servicing guidelines
Independent Real Estate Specialist	Credit reports ordered by Loan Officer, Mortgage Broker, or Loan Processor. (Real estate specialist does not originate loan.)	Underwriter obtains mortgage insurance approval, if needed; Independent appraiser provides property valuation		Closing attorney prepares loan documents, orders title record, obtains title insurance; after closing, records documents and pays fees to insurers	Mortgage insurer collects annual or monthly premium
Who Uses Loan Data?		Loan Processor puts credit info, approvals, appraisal and commitments in loan file	Loan Processor completes loan file with missing data	Closing attorney completes document files and delivers it to Lender/Servicer; GSE collects LTV, income/debt service data for secondary market underwriting	Servicer consolidates closing documents into loan file and updates loan file with payment and servicing info

The Conforming Mortgage Loan Process with Competitive Automated Underwriting (AU) Systems

	Application	Approval	Documentation	Closing	Servicing
Consumer	May prequalify self over Internet then makes application to lender; pays fees for credit report and appraisal	Consumers with Internet access can apply through Lender or gateway website, entering AU data on-line. Lender will notify Consumer of AU approval and conditions by e-mail	Provides missing data for loan application and credit report; selects closing attorney that can use bank AU	Signs documents at closing; approves fee payments to lender, GSE and title/mortgage insurers	Makes loan payments
Lender/ Servicer	Loan Officer/Broker takes application and may do AU pre-approval	Loan Specialist runs AU model to obtain approval subject to missing data and verifications and adequate appraisal value; Underwriter familiar with AU model criteria reviews AU declines and credit exceptions	Loan Specialist obtains missing data, orders appraisal, advises consumer of its lender network and produces closing documents by AU	Loan Specialist completes loan file to conform with AU specifications and any Underwriter special instructions; Loan Officer authorizes funding and collects origination fee	Servicer collects loan payments and monitors payment status in return for a servicing fee negotiated with GSE; sends P&I payments to lender
GSE	Makes AU system available to lenders for a fee	Sets underwriting standards and program guidelines for loan purchases, which are subject to Lender reps and warranties; GSE may choose to loosen reps/warranties if its AU is used; GSE may waive MI if its AU approves GSE high-LTV programs with risk-adjusted pricing	Sets documentation standards for different programs; makes closing software that is integrated with its AU available for a fee	GSE purchases closed loan, then packages and sells it in the secondary market; GSE collects fees related to risk-adjusted loan programs	Collects GSE/Investor loan guarantee fee; sets servicing guidelines; collects annual risk fee for high-LTV programs; makes servicing software that is integrated with its AU available for a fee
Independent Real Estate Specialist	Credit reports ordered by computer through AU	Loan Specialist obtains mortgage insurance approval, if needed; Independent appraiser provides property valuation		Closing attorney orders title record, obtains title insurance; after closing, records documents and pays fees to insurers	Mortgage insurer collects annual or monthly premium
Who Uses Loan Data?		AU compiles loan data, automated approvals, appraisal into computer-based files; for GSE AU and GSE special programs, credit data available to Lender and GSE	Loan Specialist updates file with missing data info; Lender or GSE may add property info to databases	AU generated closing documentation added to file with other closing data; GSE compiles LTV, income/debt service data for secondary market underwriting	Servicer consolidates remaining documents into AU computer file and updates AU file with payment and servicing info

The Conforming Mortgage Loan Process with GSE Monopoly Automated Underwriting (AU)

	Application	Approval	Documentation	Closing	Servicing
Consumer	May prequalify self over Internet then makes application to lender; pays fees for credit report and appraisal	Consumers with Internet access can apply through Lender or gateway website, entering AU data on-line. Lenders will notify Consumer of AU approval and conditions by e-mail	Provides missing data for loan application and credit report	Signs documents at closing; approves fee payments to lender, GSE and title/mortgage insurers	Makes loan payments
Lender/ Servicer	Loan Officer/ Broker takes application and may do AU pre-approval	Loan Specialist runs GSE AU model to obtain approval subject to missing data and verifications and adequate appraisal value; Underwriter may re-evaluate GSE AU declines and credit exceptions to re-examine loan application or to qualify Consumer for non-GSE loan or accept rep/warranty risk	Loan Specialist collects data, orders appraisal confirmation, prints out loan documents, schedules closing through a GSE network attorney	Loan Specialist completes loan file to conform with AU specifications and any Underwriter special instructions; Loan Officer attends closing to authorize funding and collect origination fee	Servicer collects loan payments and monitors payment status in return for a servicing fee negotiated with GSE; sends P&I payments to lender
GSE	Makes AU system available on Internet and to lenders; GSE AU loan score sets level of diligence required in credit reports	Lender pays an AU fee when it submits the loan; GSE commits to purchase loan as underwritten, subject to Lender reps and warranties; GSE may waive MI if AU approves loan for high-LTV risk-adjusted price programs	AU closing documentation interface prepares closing docs for a fee. AU uses property database to assess value for a fee	Purchases closed loan, then packages and sells it in the secondary market; GSE uses internal data for refinance title chain, scaling back title insurance requirements; GSE collects fees related to risk-adjusted loan programs;	Collects GSE/Investor loan guarantee fee; sets servicing guidelines; GSE makes AU servicing interface available for a fee which is negotiated with servicing fee
Independent Real Estate Specialist	Credit reports ordered in accordance with GSE AU specs	Lender obtains mortgage insurance approval if consumer does not fit GSE high-LTV profile	Appraiser confirms GSE AU-generated property value	Closing attorney obtains title insurance as required with GSE AU requirements; after closing, records docs and pays fees to insurers	Mortgage insurer collects annual premium
Who Uses Loan Data?		AU data on approvals, and denials/referrals available to GSE and lender	Property data available to lender and may be added to GSE databases	AU generated closing documentation added to file with other closing data; GSE collects LTV, income/debt service data for secondary market underwriting; title info added to GSE database	AU file transmitted to Servicer to consolidate with paper documents and update with payment, servicing info

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