



Without a **Technology Vision,**

Every academic, bank chief executive officer and politician has his or her own idea about reforming the financial and mortgage systems in America. The Dodd-Frank Wall Street Reform and Consumer Protection Act is the objective and catalyst for the current debate on reform.

Like Dodd-Frank, opinion leaders offer structure without vision. Their intellectual concepts do not consider the capabilities of lenders to survive, much less prosper, after reform. The most far-reaching financial services legislation in 80 years has been passed without benefit of an impact assessment.

My main issue with the law is that financial reform does not consider the technology available to lenders. Here, I refer to technology in the larger sense. Technology in my thesis means the combination of know-how and the application of machines, software and people to manage under new rules.

MORTECH data have shown over many years that most lenders do not have the risk-management and business intelligence systems to run their business effectively. Lenders are underinvested in business intelligence and risk-management systems. The effect of financial reform undoubtedly will be diluted unless and until lenders conform to professional management standards enabled by (decision) technology.

Solutions offered by the experts

The Mortgage Bankers Association (MBA) has jumped into the Dodd-Frank rule-writing melee with both feet. MBA says that it has assigned an inordinate, but appropriate, set of resources analyzing and influencing rule-maker

response to the Dodd-Frank Act.

MBA recommends that the centerpiece of restructured federal support for the secondary mortgage market would be a new form of mortgage-backed security (MBS) issuer—the mortgage credit-guarantor entity (MCGE). Under its

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reform proposal, MBA envisions that a mortgage-backed security would have two components:

- A security-level, federal government-guaranteed “wrap”; and
- A private, loan-level guarantee from a MCGE.

The MCGEs would be privately owned, but government-chartered and regulated. The guarantees of timely payment of principal and interest would be secured by a federal insurance fund, fueled by risk-based fees charged for the securities at issuance, and on an ongoing basis.

Underlying the MBA concept is a minimally encumbered flow of credit to qualified borrowers. MBA also would preserve “reasonable levels” of lender discretion when originating low-risk loans.

The private-market alternative

Stumping from their rostrum at the American Enterprise Institute (AEI), Washington, D.C., Peter Wallison, Alex Pollock and Edward Pinto think they have a solution to housing finance reform—namely

removing government almost entirely. In their new paper, *Taking the Government Out of Housing Finance: Principles for Reforming the Housing Finance Market*, the three intellectual powerhouses illustrate how they would push mortgage finance away from government involvement.

The most salient point in their thesis for a new secondary mortgage is this: “To the extent that regulation is necessary, it should be focused on ensuring mortgage credit quality.” The government’s stake in the business would be focused on a higher standard of lender identification and management of risk.

MBA and Wallison, Pollack and Pinto differ markedly about government involvement in terms of its liability for carrying and managing credit risk. The AEI team holds that investors will buy mortgage paper not guaranteed by the U.S. government. Liquidity in the market would occur organically, they say.

In the MBA proposal, the guarantee would be paid from risk-based fees assessed on those private-market entities that create the securities. Under its proposal, MBA foresees that the federal government should provide an explicit credit guarantee on a limited class of MBS.

A middle-of-the-road alternative

Mark Zandi, chief economist of Moody’s Analytics, West Chester, Pennsylvania, has considered a range of mortgage finance reform models—nationalization, privatization and, well, a “hybrid” solution.

The hybrid mortgage finance system features risk sharing. Initially, Zandi would allow private operators to bid for basic government-sponsored enterprise (GSE) transaction and processing systems

Financial Reform at Risk

needed to replicate secondary market operations. Zandi states: “Administrative, oversight and review functions would be ceded to the federal government. The government would maintain control over granting charters, establishing capital requirements, running compliance audits, etc. FHFA [the Federal Housing Finance Agency] would regulate the new entities, not much differently than commercial banks are regulated.”

The private operators would invest their own capital in the credit enhancement and portfolio businesses. They would originate, own and manage the mortgage assets and the insurance portfolios.

In my view, such a system could hold the most promise for delivering consistent, affordable mortgage loans on prudent terms to borrowers, with minimal costs to taxpayers.

According to Zandi, the private operators would absorb first losses and operating cost. The federal government would backstop in case of catastrophic losses. Zandi believes that such a system retains the incentives for the operators to run a

prudent book of business, with loans priced appropriately for cost and risk. And what of the government’s role? The government backstop would help to lower asset risk premia, lower borrower costs and keep mortgage credit flowing freely.

The role of technology

It never fails—no one ever seems to offer the complete solution to reform or, for any other matter, of magnitude.

We at MORTECH LLC have long held that underinvestment in data and knowledge technologies chronically contribute to financial crises. The most telling is lenders’ lack of understanding of the risk they create when originating a loan or when investing in mortgage servicing rights.

For example, at the height of the credit crisis, only one-third of lenders had the ability to manage interest-rate risk in their pipelines (see Figure 1).

Dodd-Frank, MBA and the American Enterprise Institute notwithstanding, financial reformers will have a rough go unless lenders have the tools and the

know-how to manage their businesses better.

The Dodd-Frank Act is a lengthy document. Technology gets only nine mentions throughout the whole act. Generally these references are to technology that might be used by regulators themselves.

Financial reform will be more suc-

cessful if Dodd-Frank had a complete vision supporting it. Then, too, the interpreters and influencers of the rule-making to follow would be more persuasive working with a model of business and with technology standards.

GSEs an important source of technology innovation

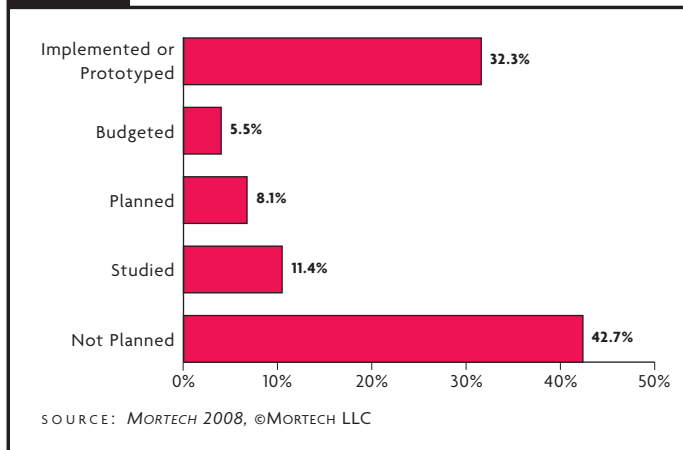
If only one-third of lenders have technology to measure the risk they create in originating a loan, two-thirds of the industry will be hard-pressed to respond smartly in a highly stringent regulatory environment.

Good management and true compliance are less about following a set of rules than they are about management will and technological know-how. Dodd-Frank *et al* never ask, “Where will the industry get the technology to better handle risk and how will they pay for the new capability?”

According to the MORTECH 2010 survey of mortgage lenders’ use of technology, 80 percent of lenders each spent less than \$500,000 on all technologies in 2010. Fifty percent spent less than \$100,000 in 2010. Not much with which to work! Not really anything for research and development.

With such small budgets, where will the industry turn for technology innovation? Over the years, Fannie Mae and Freddie Mac have built technology to help lenders with compliance, underwriting, pricing, delivery, collateral valuation, risk measurement, and so on. After reform, what will remain of the agencies’ pool of capital directed to modernizing the mortgage industry technology infrastructure? What new mechanism will emerge to efficiently disseminate new technology?

Figure 1 Only One-Third of Lenders Have Automation to Manage Pipeline Rate Risk



The GSEs have invested heavily over the years to modernize the processing and decision infrastructure of the mortgage industry. The GSEs invested, as individual lenders could not. Nowhere is the discussion of how in reform these capabilities will be maintained and enhanced.

In 1995, Fannie and Freddie introduced their commercial versions of Desktop Underwriter® and Loan Prospector®. Because Fannie and Freddie were in a central position with close communication with the industry, use of automated underwriting more than trebled between 1995 and 2000. According to MORTECH LLC, 25 percent of lenders used an automated underwriting system (AUS) in 1996. By the end of 2000, 90 percent of lenders were on board with automated underwriting. The speed of AUS adoption was unprecedented.

Compare lenders' pace of adoption of the no-less-important pipeline risk management to that of automated underwriting. Occupying a central node in the industry, the GSEs proved to be very effective technology innovators. Policymakers and influencers would do well to recognize this, and preserve or replace the agencies' technology gifts to the industry.

The vision to reform financial companies should incorporate a research-and-development (R&D) fund to facilitate the development of practical technology that can measure and warn of the risks that contributed to the financial collapse of 2007–2008.

The industry certainly would be the better for it.

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