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An Update on the Evolution of the Mortgage Origination Process[9]

One of the reasons for the rise in refinancing efficiency in 2001 is a continuing automatization and simplification of the mortgage origination process. We provide an update on the recent developments.[10]

Automated Underwriting Systems

Automated underwriting systems (AU) were first introduced in 1995 and have gained in popularity ever since. The most common AU systems are those introduced by the GSEs, Loan Prospector (LP) by Freddie Mac and Desktop Underwriter (DU) by Fannie Mae. Many large lenders also have their own proprietary AU systems.

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[9] The author would like to thank Lakhbir Hayre and Robert Young for their help in writing this article.

[10] See "The Evolution of the Mortgage Origination Process," Salomon Smith Barney, January 1999 and "The Impact of the Internet on Mortgage Prepayments," Salomon Smith Barney, February 2001.

AU systems may recommend significant shortcuts in loan underwriting.

How do the AU systems work? Let us look, for example, at Loan Prospector. A loan officer enters the loan information into the system. It takes just few minutes for LP to order a credit report, evaluate the data, and return one of the two decisions: "Accept" or "Caution."[11] If a loan is rated Accept, it can be delivered to Freddie Mac. In this case, LP determines a level of documentation required to support the underwriting of the loan. The lender will validate the data, make changes (if necessary), and resubmit the loan, which would now be on its way to the closing. If LP returns a Caution decision, it does not mean that the loan application will be rejected or that the loan is not eligible for sale to Freddie Mac. Instead, such a loan has to be examined by an underwriter, and may either follow the standard closing path or be resubmitted to LP, after changes are made.

LP may also do the following:

Recently, Freddie Mac pioneered a no-appraisal option.

- Suggest a streamlined property appraisal, such as an exterior-only inspection or appraisal. The decision is based on a statistical model, supported by an extensive property database. Recently, Freddie Mac pioneered a no-appraisal option, in which LP may waive the appraisal requirement for certain purchase loans with an 80% maximum LTV.
- Allow reduced mortgage insurance coverage. LP may also arrange a purchase of the coverage with an insurer of choice.

AU systems are extremely popular with lenders because they significantly reduce the lender's costs of underwriting loans and provide an important risk management tool. Freddie Mac estimates that the use of LP can lower the costs of originating a loan by as much as $650. About two-thirds of all GSE-purchased loans are underwritten with AU systems.

Internet versions of LP and DU are available to thousands of mortgage brokers across the country.

Both GSEs recently released Internet versions of their AU systems. This is an extremely important development because it put AU systems in the hands of thousands of mortgage brokers and wholesalers across the country. For example, more than 10,000 brokers and 300 wholesalers have access to Freddie Mac's LP only.

For an investor, who is mostly concerned with prepayments, the popularity of AU systems means the following:

- The time between loan application and closing has been shortening considerably. This shorter turnaround could already have been observed in January 2001. When the 30-year mortgage rate dropped below 7% during the week of January 12, 2001, the volume of refinance applications skyrocketed (as reflected in the MBA Refinancing Index for that week). A large portion of these refinance applications closed in less than three weeks, leading to a substantial rise in January Fannie Mae prepayment speeds.
- Because part of the AU-induced cost savings is typically passed on to borrowers, refinancing costs have been declining. Consequently, refinancing efficiency is increasing.[12]

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[11] For FHA or VA loans, it is "Accept" or "Refer." A Refer decision is similar to a Caution decision for conventional mortgages.

[12] See "Refinancing Efficiency Increased, But . . .," *Bond Market Roundup: Strategy,* May 18, 2001.

- Many borrowers, especially those who are credit-impaired and previously could not find economically viable opportunities to refinance, may now find better execution with AU systems.

While the previous three items may point to faster future speeds, the next two may indicate some speed reduction.

- With the help of AU systems, GSEs now underwrite Alternative A and A- loans. Even though these loans are placed in general pools, investors can often recognize pools with a large percentage of such loans by a high spread between the WACs and the prevailing mortgage rates at origination. Such loans are expected to prepay somewhat more slowly than standard conventional loans. For example, in 2000, Freddie's 8.5s of 1999 prepaid more slowly than their Fannie counterparts, most likely because of a large concentration of Alt A loans.
- AU systems qualify a larger number of borrowers than the traditional underwriting process. This happens because the AU systems use an overall borrower profile to make the decision. One risk factor that can disqualify a borrower during manual underwriting may not, necessarily, be a reason for rejection during automated underwriting, if some other mitigating factor is present. Even though this does not necessarily increase the default risk for the GSEs, it may still affect an average borrower's ability to refinance.

Manual Underwriting

GSEs have been expanding eligibility criteria for manual underwriting.

Loans that do not pass the AU system scrutiny or those that are underwritten without an AU system[13] go through the standard manual underwriting process. This process generally involves more restrictive guidelines, and some programs available with AU systems are not available for manual underwriting. Nevertheless, GSEs have been expanding eligibility criteria for manual underwriting. Recent developments include:

- The expansion of eligibility criteria to include loans with higher LTVs, especially for borrowers with high FICO scores;
- The simplification of underwriting guidelines to emphasize a borrower's continuity of income rather than the length of employment;
- The streamlining of standard documentation requirements; and
- The introduction of streamlined appraisals.

Streamlined Refinancing Program

The streamlined refinancing program is one of the most simplified programs available to refinancers nowadays. It is this program that is commonly blamed for the high speeds during the 1998 and 2001 refinancing waves.

The streamlined refinancing program is available with both manual and automated underwriting, and allows the use of substitute documentation to verify borrower's credit, employment, income, and assets. Most importantly, it provides for the possibility of an appraisal waiver.

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[13] Why would a lender underwrite a loan without an AU system? There is a nominal fee associated with AU-underwritten loans. Small lenders sometimes choose not to use an AU system because, for certain loans (e.g. streamlined refinance loans), the requirements are so nominal that AU systems are perceived to have only limited value.

Important features of the streamlined refinancing program include the following:

- It is open only to the current servicer of the existing loan.
- It imposes restrictions on cash-outs (only limited cash-outs are allowed).
- Freddie Mac has a 12-month seasoning restriction for loans that are not owned by Freddie Mac. Fannie Mae has no such restriction.
- It allows simplified documentation and verification procedures.
- It is open to borrowers with a satisfactory payment history for the previous 12 months (or for the life of the loan).
- It does not require a new appraisal if a lender can warrant that the value of the property did not decline since the original appraisal.

With the streamlined refinancing program, a qualifying borrower can save as much as $400-$500 in origination costs.

Lenders typically pass some of the savings produced by the use of streamlined refinancing on to borrowers. Qualifying borrowers can save as much as $400-$500 in origination costs.

Streamlined Purchase Program

The streamlined purchase program is a relatively new development, introduced by GSEs to help lenders to defend their servicing portfolio against runoffs. It allows a lender to use simplified documentation and verification procedures to finance a home purchase for a borrower who currently has a loan with this lender, provided that the borrower has a 12-month satisfactory payment history.[14] It is available with both automated and manual underwriting. However, unlike the streamlined refinancing program, the streamlined purchase program does not provide for an appraisal waiver.

At this time, it is too early to say if this program will have a significant impact on prepayment speeds.

Conclusion

New technologies and expanded underwriting criteria have been making the mortgage origination process much simpler and more cost efficient. The rise in refinancing efficiency witnessed during the 2001 refinancing wave has been caused, in part, by innovations in the mortgage origination arena. Among the changes that occurred between 1998 and 2001, we would like to underscore the following two:

- The introduction of the Internet versions of LP and DU. The Internet availability of these products put AU systems in the hands of thousands of mortgage brokers across the country.
- A streamlined property appraisal, which is available through the AU systems and, to a limited degree, through the manual underwriting. The use of streamlined appraisals may reduce the appraisal cost by 20%–75%.

[14] Twelve-month satisfactory payment history is required with the current servicer, not necessarily with the same loan.

In spite of significant advances in the past few years, the technology-driven streamlining of the refinancing process has not yet run its course. The trend of declining origination costs and faster loan approvals is likely to continue in the future.[15]