

Policy Thicket Complicates Efforts to Take Lending Online

ORIGINATING MORTGAGES online currently is like trying to fit a square peg into a round hole, at least from a public policy standpoint.

Mortgage lenders must resolve a host of challenges perpetuated by existing regulations before they can electronically replicate the traditional loan-origination experience in which loan officers meet with loan shoppers.

Those lenders who have tested online origination have found that mortgage-finance regulations written before the emergence of the Internet are not evolving quickly enough to allow for complete development of online services. Furthermore, mortgage firms aiming to compete in the electronic business arena also have discovered they must contend with problematic Internet policy and security issues that transcend industry boundaries.

Quite likely, few of these issues will meet with easy resolution. Still, the lure of conducting business in cyberspace has proven too powerful for the real-estate and housing-finance communities to ignore (see "Internet Business Is Booming," page 11). The Internet has won over many companies



that view it as a comparatively low-cost origination channel that enables highly customized consumer services. In 1998 alone, online originations were expected to reach \$10 billion, or approximately 1 percent of total mortgage volume, according to Myers Internet Services, a mortgage-finance consulting firm. By 2005, one-third of mortgage originations will travel the Internet from start to finish, industry consultants Killen and Associates predict.

Although some aspects of mortgage lending are handled electronically with ease—thus, more quickly and cost-effectively—others still require an old-fashioned exchange of paperwork to satisfy regulatory expectations. When industry regulations and statutes do not easily transfer to an electronic business environment, they can

hinder progress toward full electronic lending and its potential benefits.

by Craig C. Thomas

Borrower Disclosures at the Touch of a Button

Federal laws such as the **Real Estate Settlement Procedures Act (RESPA)**, the **Truth in Lending Act (TILA)**, and the **Equal Credit Opportunity Act (ECOA)** aim to protect homebuyers by mandating disclosure of transaction costs, mortgage terms and other information. RESPA further requires borrowers to sign documents attesting to their receipt and review of disclosures. Until recently, paper and ink have offered the only practical means of providing disclosures and obtaining borrower signatures. The Internet now offers an attractive alternative. Posting documents on a Web site or delivering them to borrowers via electronic mail could meet the disclosure requirement at a fraction of the costs of printing and mailing.

Recognizing the advantages of electronic disclosure, the Federal Reserve Board in March 1998

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proposed online disclosures (with the borrower's consent) to meet TILA and ECOA requirements and is expected to give final approval in 1999. The Department of Housing and Urban Development (HUD), in contrast, has not indicated if lenders will be able to use online methods to meet RESPA's disclosure and borrower signature requirements. Therefore, even if the Fed implements its proposal, lenders still must comply with RESPA by printing and mailing paper documents to borrowers, who then must sign and return them.

Consumer-Protection Law Working Against Borrowers?

Congress enacted RESPA 25 years ago to ensure that consumers receive full disclosure about the costs of a home purchase and to protect consumers from abuses leading to high settlement charges. Thus, the statute prohibits referral fees. Confusion, though, about what the rule intends and how it should work has fueled a long-running controversy. Many in the mortgage industry now would like to see RESPA revised or even repealed. As online mortgage lending develops, more and more questions will arise as to how well RESPA works in the online environment.

The large and growing number of online mortgage providers presents borrowers with a cornucopia of information and choices that were unimaginable a

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few years ago, much less in 1974 when the RESPA rule was written (see "Online Mortgage Business Puts Consumers in Driver's Seat," page 2). The kinds of abuses that RESPA sought to address were in large part the result of the limited information and competitive choices available to borrowers two decades ago. Although the development of online lending does not negate the need for consumer protection laws, policymakers must guard against erecting impediments to innovation. The RESPA referral-fee prohibition inhibits online service providers from bundling closing services and fees paid by borrowers into one, less-

expensive package. The ironic and unintended result is that RESPA, which was meant to give consumers a better shake, potentially could undermine the cost savings that make online lending financially attractive to borrowers.

When Does a Global Village Become a Community?

Most mortgage originators are either depository institutions or mortgage banking subsidiaries of depositories. Under the 1977 Community Reinvestment Act (CRA), regulatory approval for mergers and expansions is determined, in part, by gauging how well depository institutions serve the credit needs of the low- and moderate-income neighborhoods within the communities in which they operate. In practice, regulators assess performance by measuring such things as geographic distribution of lending activities and branch offices, as well as characteristics of the borrowers served.

The Internet, of course, transcends geographic boundaries, creating some difficult challenges for both regulators and depositories. One challenge relates to maintaining branches. A growing number of depositories provide online banking services to people living outside geographic areas served by their branches. Additionally, regulators in 1995 began chartering "virtual" depository

Have Modem Will Shop Internet Business Is Booming

Businesses of all types are chasing new revenue sources by creatively delivering goods and services via the Internet. The housing-finance industry is no exception.

All this activity is hardly surprising given the stunning growth of the Internet during the 1990s. The number of Americans online mushroomed to 62 million in 1997 from fewer than 5 million only four years earlier, according to the most recent World Wide Web User Survey conducted annually by the Georgia Institute of Technology. Depending upon the source—a host of market-research firms publish estimates of Internet demographics—as many as 80 million to 100 million American adults, as of year end 1998, routinely could access the Internet from their homes or work. As computer technology continues to become both easier and less expensive to use, these numbers certainly will grow.

Consequently, anyone seeking to purchase or finance a home in today's U.S. real estate market can use the Internet to:

- View property listings nationwide
- Obtain information on a neighborhood's demographic characteristics, property-tax rates, crime statistics and schools
- Learn, in great detail, how to buy a house and obtain mortgage financing
- Use interactive tools to calculate loan payments by principal and interest, compare the costs of renting and buying, determine whether refinancing would save money and gauge the affordability of a particular mortgage at a specific income level
- Comparison shop among lenders for the best loan rates and terms
- Obtain a personal credit report
- Lock in a mortgage rate and apply for a loan online

The National Association of Realtors (NAR), one of the first traditional industry players to jump online, now provides Internet listings for more than 1 million homes on its Web site (www.realtors.com). Freddie Mac uses its Web site (www.freddie.com) to provide information to lenders, securities investors and shareholders and also has a site (www.homesteps.com) to market the firm's inventory of

25,000 refurbished properties to homebuyers nationwide.

Major mortgage lenders—such as Countrywide (www.countrywide.com), NationsBank (www.nationsbank.com) and Norwest (www.norwest.com)—provide online mortgage services through state-of-the-art Web sites.

Added to the many mortgage brokers that also have set up Internet shops to attract loan applications are a number of start-up companies—most notably E-Loan (www.eloan.com), Get Smart (www.getsmart.com) and HomeShark (www.homes shark.com). These newcomers have settled on the mortgage brokerage format as the best way to break into the online-lending business.

Another new source of online-lending competition is coming from business outsiders intent upon diversifying into online real estate and mortgage services. Software giants Microsoft Corp. and Intuit are the leading new entrants crossing over into this arena. Microsoft launched its Home-Advisor site (www.homeadvisor.com) in July 1998. Intuit unveiled its QuickenMortgage site (www.quickenmortgage.com) in late 1997 and by mid-1998 was logging more than 500,000 visitors per month—double the company's expectations. The online services these companies offer resemble those provided by E-Loan or HomeShark. Yet it is Microsoft and Intuit in particular that worry traditional industry players. The technological sophistication of these two companies, their strong brand awareness and their business track records could serve them well as they move deeper into the online mortgage-services market.

Homebuyers stand to benefit substantially from lower-cost online services, no matter which companies provide them. Borrowers already are starting to realize some cost savings, due to both the increased competition and the relatively lower cost of online originations. Both E-Loan and QuickenMortgage charge an origination fee of 0.375 percent, far less than the 1-percent fee typically paid to mortgage brokers. HomeShark explicitly touts savings of at least one-half of a percentage point. Not to be outdone, Countrywide, Norwest and other lenders have offered inducements to online applicants that include interest-rate discounts, longer interest-rate locks and closing bonuses.—**Craig Thomas**

institutions. The model followed by Security First Network Bank is typical. The firm operates from a single physical office in Atlanta but extends banking services nationwide via the Internet. The virtual model may appeal to many institutions because it offers potentially huge savings in operations costs. A 1996 study by Booz-Allen & Hamilton found that a banking transaction done over the Internet costs one cent versus \$1.07 for a teller-assisted transaction in a branch office. But the wholesale closure of branches could produce negative CRA-evaluation consequences.

Another challenge relates to borrower characteristics. U.S. Internet users are wealthier than the population as a whole. The Department of Commerce estimates that in 1997 nearly 50 percent of households with annual incomes of \$75,000 or more had online access, compared to only 7 percent of households earning \$15,000 to \$19,999 and less than 5 percent of households earning \$10,000 to \$14,999. The study does not measure online access outside the home, such as in the workplace or at public libraries. Nonetheless, a depositor emphasizing online service might face questions about how well it serves low- and moderate-income communities.

To address these issues, regulatory agencies are considering how to measure CRA compliance in an online environment. Release of a policy proposal from

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banking regulators is expected in 1999. Both the Office of the Comptroller of the Currency (OCC) and the Office of Thrift Supervision (OTS) have pledged that any regulatory changes will support obligations to serve lower-income and minority households.

Fair Lending's Online Issues

In addition to grappling with regulatory issues, online mortgage providers risk running afoul of fair-lending laws, especially with respect to racial issues. According to the Commerce Department, more than 21 percent of white households in 1997 had access to

online services, compared to only 8 percent of African-American households and 9 percent of Hispanic households. Fair-lending regulators could raise concerns about lenders that do most or all of their business online, although statistics about household Internet connections do not reflect online access outside the home.

Regulators also might look askance at the practice of providing discounts to online applicants. Business practices that are race-neutral may draw scrutiny if they disproportionately affect certain racial or ethnic groups, unless the practices serve a legitimate business purpose.

The good news for online mortgage providers, however, is that the online population is likely to mirror the overall population more closely in the years to come. Computer costs will continue to decline in the foreseeable future. Online service costs have dropped to as low as \$10 per month. During 1998, a British consumer-electronics retailer announced it would provide free Internet access to its computer purchasers; a U.S. computer manufacturer or retailer could do the same. Alternatively, some technology industry analysts predict online service providers may give away personal computers in exchange for a multiple-year contract for online services, similar to the practice pioneered by cellular telephone services. While these

developments alone will not eliminate racial and income disparities, they should reduce the long-run potential for a digital divide.

State Licensing: Bricks and Mortar vs. Bits and Bytes

The Internet enables a lender located in one state to serve borrowers in the other 49 states without establishing a costly network of local offices. Current state licensing regulations, however, may negate some of these savings. Forty-eight states and the District of Columbia license mortgage lenders and **mortgage brokers** as a condition of doing business; 10 states require maintaining a physical office within the state.

By ensuring authorities are aware of who conducts business in their localities, state licensing requirements provide a line of defense against consumer scams and other illegal practices. While the costs of complying with multiple registration requirements negate some of the savings lenders could realize from going online, licensing remains a valid way to protect consumers. At the same time, the development of online lending and the national scope of today's mortgage-lending operations throw into doubt the relevance of existing physical office requirements. The costs of maintaining physical facilities superfluous to business purposes cannot help but reduce potential savings to online borrowers.



Privacy: My Business Only?

Further slowing the mortgage industry's foray into electronic lending are more general online policy issues that transcend industry boundaries.

As Internet usage expands, businesses that move online are capturing more and more personal information about consumers—including credit histories, finances, buying habits, driving records and medical histories—and subsequently circulating it to third parties, often without consumers' knowledge or consent. The information is valuable for marketing purposes and fundamental to providing customized online services. However, the compilation of this data raises concerns about security and the possibility of identity theft—the use of an individual's personal information to commit crimes like loan fraud.

A 1998 Federal Trade Commission (FTC) examination of the privacy practices of major Web sites found that fewer than one in seven disclosed to users

how personal information is used. The FTC has warned that this year it plans to seek legislation mandating privacy protections unless the private sector moves to regulate itself.

Federal depository regulators similarly are encouraging the banking and thrift industries to take the lead in protecting consumer privacy. In November 1998, the federal thrift regulator urged savings institutions to go beyond minimum legal requirements for divulging personal information by giving their customers some say in how the information subsequently is used. For the country's approximately 3,000 nationally chartered banks, the OCC is expected to release a similar regulatory policy statement soon. The agency already has warned banks that failure to protect customer information could cause a backlash restricting the industry's access to information.

Congress, too, has demonstrated a growing interest in privacy issues. Much of the 1999 legislative activity appears likely to focus on privacy, with enactment of comprehensive legislation a distinct possibility. A surprising source of support for privacy legislation may come from American companies eager to conduct European business. Effective October 1998, a European Union privacy regulation forbids disclosure of personal data to any company domiciled in a country lacking

adequate privacy protections, unless the individual affected consents to the release.

Under the European regulation, adequate privacy protections mean informing customers about how personal information will be used. Individuals also must have access to their data and the right to block its distribution. The Europeans also specify an arbitration procedure for disputes and legal penalties for violations. The U.S., which does not mandate these protections, fails to meet the European standard. Although U.S. companies could contact European customers one by one to seek consent for use of their personal information, the expense and difficulty involved may motivate them instead to lobby Congress to establish equivalent privacy protections in the U.S.

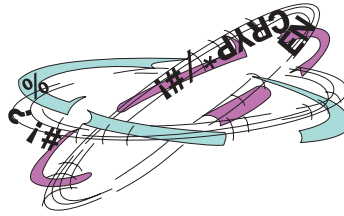
'Net Surfer Beware

Anyone can create a credible-looking online business presence for the relatively low cost of a computer, software and rental space on a Web server. This reality makes it difficult to distinguish a legitimate enterprise from a fraudulent one. A fraudulent online mortgage company, for example, might offer an enticingly low interest rate and no closing costs. Borrowers, in their rush to take advantage of such a great deal, might reveal credit card and bank account numbers—information that is not requested on the industry's standard mortgage application—

thereby giving a con artist the means to obtain unauthorized access to those accounts.

Although state and federal regulators act promptly to stop such illegal online activities, criminals can take down one site and launch another in the blink of an eye.

Such criminal activity could threaten the development of online mortgage services by reducing public confidence in the medium as a business tool and spurring the imposition of burdensome regulations for legitimate companies.



Encryption: Read My Lips, #!?!/!

The stuff of spy novels, encryption uses complex mathematical algorithms to scramble data into indecipherable gibberish that only a software “key” can unlock. The longer the key—that is, the greater the number of possible unscrambling codes—the more secure the encryption.

Encryption plays two essential roles in electronic commerce: keeping stored and transmitted data secure and authenticating documents transmitted online. Unfortunately, encryption also lends itself to misuse by criminals. Inexpensive, powerful and simple-to-use encryption products are easy to obtain—in some cases, they are offered for

free on the Internet. As a result, law enforcement and intelligence agencies now worry about their ability to conduct electronic surveillance on criminals, spies and terrorists. Seeking help, they want Congress to enact legislation requiring all encryption users to provide copies of their descrambling keys to an escrow agent that, in turn, would provide the keys on demand to law-enforcement officials. The proposal is controversial, partly because it raises concerns about civil liberties. Additionally, many cryptographers and computer security experts worry that such an arrangement could jeopardize the security of commercial sites and transactions by making repositories tempting targets for theft.

For the mortgage-finance industry, any apprehension that online commerce is less secure than traditional methods will stunt the growth of Internet mortgage transactions. A federally mandated escrow key law is likely to feed such perceptions and, if cryptographers' fears about security breaches are correct, could expose online lenders to greater risk of loss from illicit access to their systems.

Please Sign on the Digital Line

Digital signatures utilize encryption to authenticate documents transmitted online. Digital signatures employ two different but mathematically related keys. The *private* key used

to sign a document is kept by the signer and known only to the signer. The *public key* is used to verify the authenticity of the signature. Many individuals and some organizations make their public key available online via a public key registry. In simplified terms, a private key might consist of a calculation that is computed one way, while the public key would entail working the same calculation backwards.

Most states have adopted legislation to recognize digital signatures as legally valid. Because requirements vary from state to state, there is concern that conflicts between state laws could hinder the development of online commerce. While Congress has allowed the states to take the lead, it may decide that establishing a federal standard offers the best solution. However achieved, the widespread use of digital signatures will facilitate secure online commerce and can provide a convenient means for borrowers to acknowledge in writing that they have received disclosures, as required.

The Digital Taxman Cometh

While small today, the volume of electronic commerce is expected to explode. Revenue-starved governments will want to tax this stream of money. Many state and local governments fear losing a significant portion of retail sales-tax revenues to interstate online sales. They also see potential new

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revenue sources from levying taxes on other Internet transactions and on Internet access itself. If a significant number of the country's 30,000 jurisdictions start levying taxes, online business could be strangled in its infancy.

In October 1998, Congress enacted legislation that prevents state and local governments from imposing new taxes on Internet access or transactions for three years while a committee studies the issue. Few believe that the online medium will escape taxation, but only time will tell how new tax regulations will impact electronically generated mortgage business.

Jumping on the Online Bandwagon

So far, unresolved public policy issues have not choked the growth of online mortgage services, but hurdles have delayed or stopped development of online commerce at some lending institutions. Warren Myers, head of Myers Internet Services, reports that several of the consulting firm's bank and thrift clients have dismantled Web sites offering online applications after the institutions' legal departments lodged objections. However, Myers points out, this ambivalence is not shared by mortgage brokers, start-up ventures and crossover entrants such as Microsoft and Intuit that are new to real estate and mortgage services. All of the newer players are intently angling for market share.

Continued uncertainty or unfavorable outcomes associated with these issues could undercut benefits to Internet consumers. Any resulting regulatory-compliance burden would add to the origination costs ultimately born by borrowers. Furthermore, failure to ensure a reasonable level of privacy or security could scare off online customers.

Still, the rapid movement of the mortgage-finance industry to the Internet, along with the entry of new players, suggests that no matter how many obstacles or how difficult the feat, determined mortgage lenders will find a way to round off the square corners of the peg until it fits the hole. SMM