RISKY BUSINESS

OVERCOMING THE INDUSTRY'S SEA CHANGE WITH EMERGING ANALYTICS

Companies are adapting to the changing climate by producing a bevy of analytical reporting tools to increase efficiency and accuracy in the industry.

COVER STORY

By Chuck Green

Successful mortgage quality control teams are tapping into flexible technology solutions that, in turn, are yielding a gaggle of analytical reporting options.

Measures such as compare and contrast risk scores—where targeted and routine quality control audits are compared and measured in terms of the effectiveness of pre-funding origination processes—are being utilized by firms, explained Tommy Duncan, president of Quality Mortgage Services. Those tools dissect loan programs and various loan scenarios, origination locations, and individuals, he notes.

Credit Where It's Due

As for which options to leverage, some lenders defer recommendation-making to their company's credit risk department. In instances where lenders maintain a say over recommendations, their input often is overridden by operational staffs and leadership, both of whom place greater emphasis on production, Duncan says. When the production staff flouts recommendations from risk staff, though, portfolios become more vulnerable all the way through to the secondary market and servicing—and that goes hand in hand with failing to provide sufficient resources for the risk staff to properly do its job, he explains. Often, when clients don't adhere to the advice of risk staff, it's because the staff lacks proper resourcing, Duncan adds.

"Production departments will always have a heavy influence on operational policies and procedures," noted Mark Meyer, founder and CEO of MLinc Mortgage Solutions. However, risk departments are gaining in power and authority, and the chance of violating regulations and the associated cost of noncompliance are weighing heavily on the minds of C-level executives in the industry, Meyer said.

Given today's often daunting workloads, though, risk departments typically devote little-to-no time to drilling down into the details that would otherwise help them most effectively evaluate potential weaknesses or vulnerabilities in origination processes, Duncan notes. Frustratingly, he says, that can culminate in repeating the same, potentially incorrect, actions.

Concurrent to that, Duncan pointed out, the industry is seeing quality control and risk personnel leveraging "robust" technologies that abet management responses. As a result, those individuals can hold origination staffs accountable for mistakes and defects. "Once [members of] an origination staff have to stop work, respond, and report to the quality control manager a few times for the same problem, quick changes in behaviors and practices [tend to follow]," Duncan said.

"Lenders are overwhelmed [as they] absorb which new regulatory requirements will apply to them, and the associated risk of noncompliance," Meyer said.

Once they understand the new requirements—and the potential financial, litigation, and business interruption cost of noncompliance—more lenders will actively re-engineer how they operate, Meyer explains.

Furthermore, he says, the availability of prefunding systems and technology for early detection of problems, the required coordination of settlement service providers and information, the timing of new disclosures, and the necessity for quick response to mitigate risk strongly motivate lenders to rethink their origination process.

Tides of Change

Meantime, Avi Naider, CEO of ACES Risk Management Corp., noted that "in just the past few years, we've observed a sea change in the way quality control analytics are being used by lenders—from origination through securitization." Previously, analytics and trends were analyzed ex post facto—long after the origination of a loan, Naider notes. Today, however, process defects and trends are being identified in real time and communicated back to those responsible for such defects, such as brokers and underwriters, "with lightning speed," he added.

That rapid reaction time partially stems from process improvements, such as a focus on prefunding quality control and analytics, driven by the GSE LQI initiatives: loans and parts of the origination process that are problematic can be identified before the loan closes, Naider explains.

Successful analytical strategies take into account not only relevant market data, like recent sales and listings, but the ever-evolving landscape of regulatory compliance and data standards as well, said Alex Villacorta, director of research and analytics at Clear Capital. Providing automated rules and quality checks at the point of origination smooths out the path of a loan headed toward securitization, he adds.

Following origination, consistent and relevant surveillance of both the collateral and credit are key to ensuring changes in the risk profile are accurately managed, Villacorta notes.

For its part, Carrington Mortgage Services maintains a full-time department responsible for overseeing compliance, says Rick Sharga, EVP of the special servicer. The department functions apart from the company's lending group, consequently ensuring that quality matters are reviewed by an "outside set of eyes," Sharga said. "Fraud prevention is one of our primary focuses and part of our standard procedure."

Further driving home that point, Carrington also uses an automated fraud identification tool, provided by an outside vendor, which scans applications against various fraud databases. Additionally, Carrington conducts manual reviews of applications against its own internal list of possible fraud "flags," he said.

In fact, the firm addresses quality compliance so aggressively that there's sometimes friction between its origination and compliance groups, Sharga notes. But whatever disharmony that approach occasionally creates is worth it since Carrington has experienced virtually no nonperforming loans, he says.

Along those lines, Sharga emphasizes that Carrington created the compliance department not due to any problems it was experiencing with its lending program, but because of the havoc stemming from the overheated market a number of years ago.

"Frankly, our investment group had put a lot of money into portfolios of subprime loans, so we saw firsthand many of the problems with loans and lending practices during the real estate boom," Sharga explained. "When we decided to enter the origination business, we were determined not to make the same mistakes the lenders of that era made. In our case, it was really more an issue of problem prevention than fixing an existing problem."

High Costs for Compliance

Now, perhaps not surprisingly, the process is relatively expensive to execute, particularly to the degree at which Carrington operates its business. The company has about 2,500 employees across its various business units, but only a few hundred are in the lending operation, Sharga says. However, "if it improves the performance of your loan portfolios, you figure you'll be better off in the long run," he pointed out. In fact, fueled by some of the more challenging regulatory requirements and more complicated regulations now facing the industry, it's likely that many companies will follow Carrington's lead, Sharga says.

On another front, Duncan doesn't believe lenders hold the majority of data solutions required to secure an upper hand in the marketplace.

"Data's a small piece of the overall evaluation for growth initiatives, while collective information is the center of gravity in terms of gaining advantages in the market," he said.

Needed most is a sensible strategic planning analysis of the national and global economies, national and global politics, future mortgage markets, and the establishment of market trigger indicators that anticipate mortgage market directions, Duncan says. Estimates that evolve from that process must be monitored weekly so that decision points can be executed to more efficiently and effectively expand or retract efforts or initiatives, he adds.

Decision making in technology involves a delicate but specific balance, Duncan says. "A loan that doesn't meet every requirement of the investor or regulator will be instantly flagged by technology and production halted, which I think involves a great deal of symmetry," he said. "In the real world, a loan that fails to meet every guideline can somehow slip through the process and continue on to funding, even though all of the data available indicates it shouldn't. That's not symmetrical, but it is real life." Ultimately, it's why technology alone never can be a solution for effective quality control in mortgage lending, he maintains.

As a result, "each lender will have to determine where they assume risks and which are allowed in order to focus growth in the marketplace," Duncan said. The combination of data and information will lead to a "reasonable situational awareness needed to make the next move," he added.

Setting Standards, Transitioning Tech

Meanwhile, while the form it will take remains nameless—albeit temporarily—the standardization of quality control applications for mandatory uploads looms as the next-gen tool, Duncan says. Mortgage bankers will be required to upload data results from prefunding and post-closing quality control, and data reconciliation will be performed between various levels of mortgage banking to affirm data and quality control consistency among levels, he explains. Furthermore, the data will be instrumental in rating loans and mortgage bankers' performances and establish standards for business relationships as well as portfolio scores.

Meyer added: "Prefunding problem detection systems will definitely help measure personnel performance, identify where processes should be changed and improved, and define training program needs."

As for defects measurement, compliance issues appear to outweigh risk issues several times over, though it's important not to underemphasize the significance of the latter, Meyer cautions. The number of risk defects that might warrant a repurchase remains high, while mortgage fraud in originations have "dropped off nicely" due to stronger prefunding quality control programs, he said.

Mortgage fraud in originations will increase with the decline of refinance and production volumes and the increase of purchase originations, Duncan predicts. "I hope I'm wrong, especially with the efforts [devoted to] reducing mortgage fraud mortgage defects," he said. "However, in my opinion, the large volumes of refinances have [provided] a false sense of security in many quality control programs."

Duncan bases his analysis on the comparison of FHA and conventional loan defects, pointing out that the sum of all conventional refinances outnumbered all FHA loan production. "While FHA defects differed from those of conventional lending . . . the FHA didn't have near the underwriting problems as the conventional loans," he said. In comparing the type of defects between the FHA and conventional loan, Duncan is unconvinced that the current quality control efforts will make much headway in the purchase market. "Appraisal defects are still flat and relatively high," he said. "For a number of reasons, I don't anticipate a reduction in appraisal defects and believe it will continue to worsen."

He attributes that point of view to a number of factors, including what he labeled the high degree of human opinion and work placed into the appraisal; the number of appraisal analytics and inconsistency in many of the appraisal technology products; market inconsistencies, which make it difficult for appraisers and technology to remain current; the lack of a new generation of appraisers; and an often heavy workload, impacting appraisal quality.

Apprising Appraisals

Lenders are doing their best to address appraisals, and many have come on line with the LQI concept and have made a number of loan quality improvements with pre-funding, Duncan adds. "If the mortgage industry wants to see improvements in appraisals, give the appraiser the same technology that's available to underwriters so they can better evaluate their appraisal and support their opinion," he said.

Along those lines, when appraisers have at their fingertips the same appraisal technology as lenders, Duncan says appraisals will be the top defect-related problem in mortgage lending. "I see many non-banks addressing compliance by recruiting personnel [well versed] in law and banking, [which will help them incorporate] improvements in mortgage compliance," he said. "While some mortgage bankers have given risk managers more leverage in production, I still see some mortgage bankers overriding risk management's recommendations, which [explains] why compliance defects [largely] outweigh risk defects."

Most lenders are well aware of the disparity of the "new normal" in U.S. real estate; the issue now is how to integrate these new analytical tools into existing systems and, more importantly, within the guidelines of various regulations, Villacorta contends.

In Case of Emergency

Mark Meyer, founder and CEO of MLinc Mortgage Solutions, suggested that one up-and-coming trend involves "lenders establishing third-party service relationships with attorneys and consultants, who are repurchase experts, for analyzing, negotiating, and mitigating associated risk and cost."

Meantime, Carrington Mortgage Services EVP Rick Sharga contends the high-tech landscape du jour involves "equal parts process improvement and technology capabilities. You want the technology to be secure and easy enough to use that you can do reports and analysis on the fly," he said. Ultimately, though, Carrington believes it's mostly about the methods employed to get the job done. "We have very strict processes in terms of documentation, [to the point of doing things like] recording all of our communication with consumers," he said. "You need technology that makes accessibility to those records reliable and easy to get at."

That way, if you need to deal with a regulatory issue or consumer complaint, you have a way to track back and make sure you did what you were supposed to do in the first place, he notes.

Not only that, Sharga says his firm's a big believer in training. "When we bring people onboard, we do a lot of training, and we've invested heavily in online training tools, so no matter where our employees are and no matter when the regulatory rules change, we can update them and make sure they're trained to be compliant."

In fact, Carrington even ties performance and behavior to compensation, an ideal way to ensure regulatory compliance remains a priority among employees, he says.