OPERATIONALIZING MORTGAGE BANKING COMPLIANCE
Bank compliance, and especially mortgage banking compliance, is complicated and high-risk, and conventional wisdom suggests it will get harder. The accountable executives are dealing with intense pressure to understand regulatory and investor demands and then to formulate and implement a strategy to meet those demands. Their strategy needs to be balanced appropriately to originate a fully compliant mortgage product, compliant with a plethora of internal and external regulations and quality standards, all while delivering an excellent customer experience and making a profit in an environment where margins have narrowed significantly since the crisis, now 8 years past.
Much has been written about the difficult work compliance experts do, as if by better understanding certain aspects of their work—operational models, best practices, pitfall avoidance, change management, and strategy formulation—banks will automatically become more successful. Unfortunately, the industry has seen little evidence this is true.

Banks are struggling with mortgage compliance, yet they know how to be compliant. Banks and professional mortgage bankers understand quite well the demands and changing requirements of their investors and the regulators. They have read the white papers, studied the government’s guidance, negotiated with their investors and spent $200 billion on outside compliance counsel and consultants since the crash, all while enduring the rigor and expense of more frequent regulatory reviews. These reviews have become more in depth with adverse findings carrying higher penalties. Consequently, mortgage banking executives have become experts at formulating strategies which they hope will allow them to operate safely and profitably within compliance guidelines.

And yet, mortgage operations still routinely run afoul of regulatory and compliance requirements on a regular basis. The cost of these compliance failures is high. Fixing compliance has become imperative to the boards of lenders. After working with hundreds of mortgage banking executives, we have concluded the problem is not with the compliance department’s understanding of the requirements—it is something far more subtle.

Good solutions can only be derived from well-defined problems. The actual problem with compliance has never been clearly defined; we’ve been acting as though a lack of understanding of the requirements was the problem.

The real problem is that mortgage originators face severe challenges in operationalizing the balanced compliance strategies they have developed, both on the floor and in their back offices. If organizations target to operate more profitably, while fully compliant within regulatory and investor guidelines and achieving higher levels of customer satisfaction, this is the problem that must be solved.

We will address this problem in this paper. In most cases, we will refer to the originator as the bank, understanding these challenges and the proposed solutions apply equally to banks, non-banks, and even mortgage brokerages industry wide.
THE OLD PROBLEM;  
THE WRONG FOCUS  
FOR THE INDUSTRY

There was a time, immediately after the mortgage and financial crash of 2007 and the passage of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank), when it was appropriate to focus on understanding the new compliance environment and the challenges faced by management formulating the appropriate strategies.

Compliance officers were quick to assimilate this new information and began formulating strategies designed to allow their institutions to operate within the new rules profitably and without business disruption and/or fines and penalties from the regulators. When these efforts failed to result in full compliance, bank management, investors and regulators assumed the strategy was flawed.

Thus, bank management has been stuck in one or both of two loops, forever going back to the beginning to find the source of the problem and formulate a better strategy. Specifically, these loops are:

The new environment for regulatory compliance

A regulatory compliance failure is often viewed as a fundamental misunderstanding of the requirements handed down by the Consumer Financial Protection Bureau (CFPB), the federal enforcer of the Dodd-Frank Act, or other financial services regulators.

While banks have been subject to banking regulators for nearly a century, the environment changed substantially with the formation of the CFPB. No longer were regulators primarily focused on providing rule-sets designed to facilitate the legal transaction of business between institutions in the various states or with foreign institutions. The new agency was established by the federal government to protect consumers from the financial services industry, which was a departure from the previous regulatory focus on safety and soundness. This created a new and heightened area of focus for the financial services marketplace.
This newly formed agency, led by an independent director and under mandate to protect the consumer, reset the way mortgages were originated and serviced, far beyond any previous governmental direction. The results have been challenging for the industry, as the CFPB imposed substantial fines and judgements for failing to comply.

The CFPB, as it stands today has created hundreds of new rules for the industry. The Bureau’s motto is: “We’re on your side.” Its public stance is, “We are the Consumer Financial Protection Bureau, a U.S. government agency that makes sure banks, lenders, and other financial companies treat you fairly.”

This is keeping the compliance departments very busy. When a compliance problem results, the typical response is to send it back to compliance for a refinement to the bank’s strategy in light of a new or misunderstood rule.

**Investor requirements and the looming buyback**

When the government took control of the nation’s largest mortgage investors and converted them from Government Sponsored Enterprises to enterprises under conservatorship, the government became a much more active force in the industry.

The government was already a key component in home finance through the FHA-, VA- and USDA-insured lending programs, yet when the Federal Housing Finance Administration took over Fannie Mae and Freddie Mac by putting them into government Conservatorship, now 10 years ago, the government took its involvement to a new level. In the process, the FHFA, became the largest investor in the home finance industry.

In an effort to better understand the loans it was guaranteeing, the government developed an intense appetite for electronic data, which could be quickly analyzed. Today, the government requires a significant amount of data related to the seller’s mortgage business, including who it lends to (HMDA), what it lends against (EAD) and the specifics of every deal (UCD). The appetite continues to grow with increased regulations.

A mistake here can result in a buyback request, which can be incredibly expensive for mortgage lenders, particularly those that do not lend against their own deposits. Fannie Mae’s new Day 1 Certainty offering is a direct result of the industry’s anxiety.
HOW BANKS HAVE TRADITIONALLY DEALT WITH THE COMPLIANCE PROBLEM

Faced with a changing compliance environment, banks have approached the problem from their traditional strength, focusing on risk mitigation. This requires the bank to first assign compliance responsibility to a capable bank executive who will either assemble a team or reach out for outside expertise or both. Banks already had this infrastructure at their disposal when Dodd-Frank was passed, yet many further invested or revamped to meet the newly increased complexities.

The compliance department then formulates positions on the various rules, as they pertain to bank functions, and works with the legal department to formulate a strategy based on risk tolerances the bank will use to navigate the market operationally.

One pillar of these strategies has traditionally been quality assurance and control, which calls for a loan review department that reviews completed or nearly completed deals for compliance against the bank’s existing business rules. QA/QC has always been a part of the bank’s operation and has traditionally run manual checklists against a subset of loans to provide bank management with a reasonable level of assurance that it is operating in full compliance.

As the cost of noncompliance has risen, technologists have focused on automating these checklists, allowing banks to examine more loans to quickly isolate those deals containing compliance problems. Those loans are then taken out of the normal production cycle and fed back into the system for rework and repair.
Unfortunately, as the rules have become more complex, this process only sends more and more loans back for rework, slowing down all loans and creating massive friction for both the lender and the consumer. When problems are identified, information is sent back to the compliance department to determine whether a new strategy will be more effective.

The result of all of this—the external experts, the additional QA/QC staff, the new technology, the re-processing of problem loans, the reformulation of strategy—is a substantial increase in the cost per closed loan. In the third quarter of 2016, the most recent survey from the Mortgage Bankers Association showed lenders were paying $6,969 per closed loan in production expenses. This is not a sustainable model and will affect bank profitability and worse, the bank’s appetite to provide mortgage products to its customers. In the end, fewer options and higher costs will negatively impact the consumer of mortgage products.

Conventional solutions offered to the banking industry to solve the compliance problem either focus on revisiting the “evolving regulatory environment,” or suggest that banks outsource specific component functions in a piecemeal fashion. Those a Bank feels carry the highest risk of non-compliance versus a more end to end solution.
REDEFINING THE PROBLEM
THE INDUSTRY MUST SOLVE

Attempting to understand the work of the compliance executive, beyond training for new executives, is not a good use of resources and unlikely to result in more compliant loans. The regulatory environment has already evolved. We know who the regulators are and for the most part what they expect of lenders. The language of certain rules will change and new rules will be presented, but this does not constitute an evolution. If anything, it will be a refinement.

It is true that bank compliance experts are dealing with a very complex ecosystem. Different rulesets handed down by different regulators exist for depository versus non-depository institutions, brokers versus lenders, lenders who originate for their own portfolios versus those that sell to the agencies, and lenders selling QM product versus those selling non-QM product and the geographical jurisdiction in which a given loan origination property will reside. Even with all of this, bankers know how to set their strategies.

What is far more difficult and, in our opinion, the source of nearly all compliance problems, is the bank’s ability to operationalize its strategic decisions regarding compliance for the teams originating, processing and closing the products it sells to ensure full conformance with the lending institution’s compliance management policies. Solving this problem will force the bank to stop focusing on external sources of compliance frustration and begin to focus on the operational resources available internally for the manufacturing of compliant mortgage loans.

However, focusing on new technologies or better staff for the QA/QC department will at best allow the bank to do a better job of locating problems once they have occurred. While there is some benefit in this, it’s not the solution banks are seeking.
Likewise, identifying which functions carry the most compliance risk is a useful exercise, yet outsourcing only those functions to firms specializing in those functions simply layers on origination costs, as the lender will still have to maintain vendor management staff and technology to work with the new partners. While outsourcing risky functions is a proven strategy for mitigating those risks, piecemeal BPO fails to be cost effective and adds its own risk to the enterprise, including additional compliance risk.

In fact, the industry has learned that given the rapid pace of regulatory change, it is incredibly difficult to keep multiple compliance-related technology platforms operating in sync. Fewer systems are easier to manage, waste less executive time with false positive compliance warnings and decrease expense. Similarly, too many hand-offs between the lender and third-party compliance solutions create unnecessary complexity and actually increase the risk of a compliance violation. A more holistic view of the problem and the integration of advanced and nimble, more flexible technologies has been impossible in an environment where too many piecemeal investments compete for primacy.
BUT BANKS MUST STILL OUTSOURCE THE MORTGAGE LOAN PROCESSING AND UNDERWRITING AND DATA INTEGRITY FUNCTIONS

This is a conundrum for the bank as it does not have the resources internally to effectively operationalize the strategies handed down by its internal or external compliance experts. Even if the institution was fortunate enough to have a team that could perform in a fully compliant manner on every loan the bank originates in every jurisdiction, it would likely struggle to scale that operation. Therefore, banks must outsource.

If piecemeal outsourcing is problematic, outsourcing everything to the same outsourcing partner can be just as challenging and yet the vast majority of successful banks will do this in the future.

After an exhaustive survey of the industry, the survey results show banks intent on remaining in the mortgage business must find a way to mitigate the risks inherent in partnering with a single end-to-end mortgage origination provider. Focusing your search on the following four factors will help locate the right partner and mitigate these risks.

Focus on THE PEOPLE

Mortgage Loan processing, underwriting and maintaining data integrity throughout the origination life cycle are expert processes that require expert personnel in every department. Every person involved in the process on the vendor side should be at least as competent as the bank’s own internal staff and preferably more experienced. Further, the outsourcer must be capable of providing an environment that fosters an intimate working relationship between its staff and the bank’s. Despite outsourcing the entire loan origination process, from origination to post-close, the bank’s own personnel will always be part of the successful team.
Focus on THE PROCESS

People executing the processes need proven processes guiding their work, setting standards for its completion and checking for compliance problems real time. Because compliance requirements change often, these processes must be malleable enough to keep pace, yet strong enough to guide expert personnel without confusion. Any potential partner should be able to explain how their work flows, how they adapt to changing requirements and how feedback provides compliance assurance at every step.

Focus on THE TECHNOLOGY

No part of the modern mortgage lending enterprise functions well without good technology, and technology is even more important in ensuring compliance. Any potential partner should be prepared to showcase their technology, the expert staff and methods they use to keep their technology updated, and how they train their people to make best use of its strengths. This is by far the most expensive and challenging aspect of compliance for the bank and one of the biggest benefits the right outsourcing relationship can offer.

Focus on COMPLIANCE ASSURANCE

Bankers do not gamble on their business and any potential partner the bank chooses should be prepared to explain what types of warranties or assurances they offer with respect to execution of the bank’s compliance strategies that a fully compliant and profitable loan origination business will result from the relationship. Few companies have the financial wherewithal to warrant the results of their efforts, though this should not be too much for the bank to require.

Banks know how to formulate a winning strategy. What they need is a way to consistently operationalize the winning strategy so every loan they make is fully compliant to their standards while ensuring that every borrower is very well served. As bank executives focus on this problem, we expect more institutions to seek out end-to-end mortgage origination outsourcing partners to fuel the solution.
References


4 ibid.


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