# THE Mortgage Industry Reformation

BY MARY KLADDE AND RUTH LEE

**These are times of zero tolerance. Get it right from the start is the new mantra for loan quality. Industry survivors must become true believers if investors are going to come back into the fold.**

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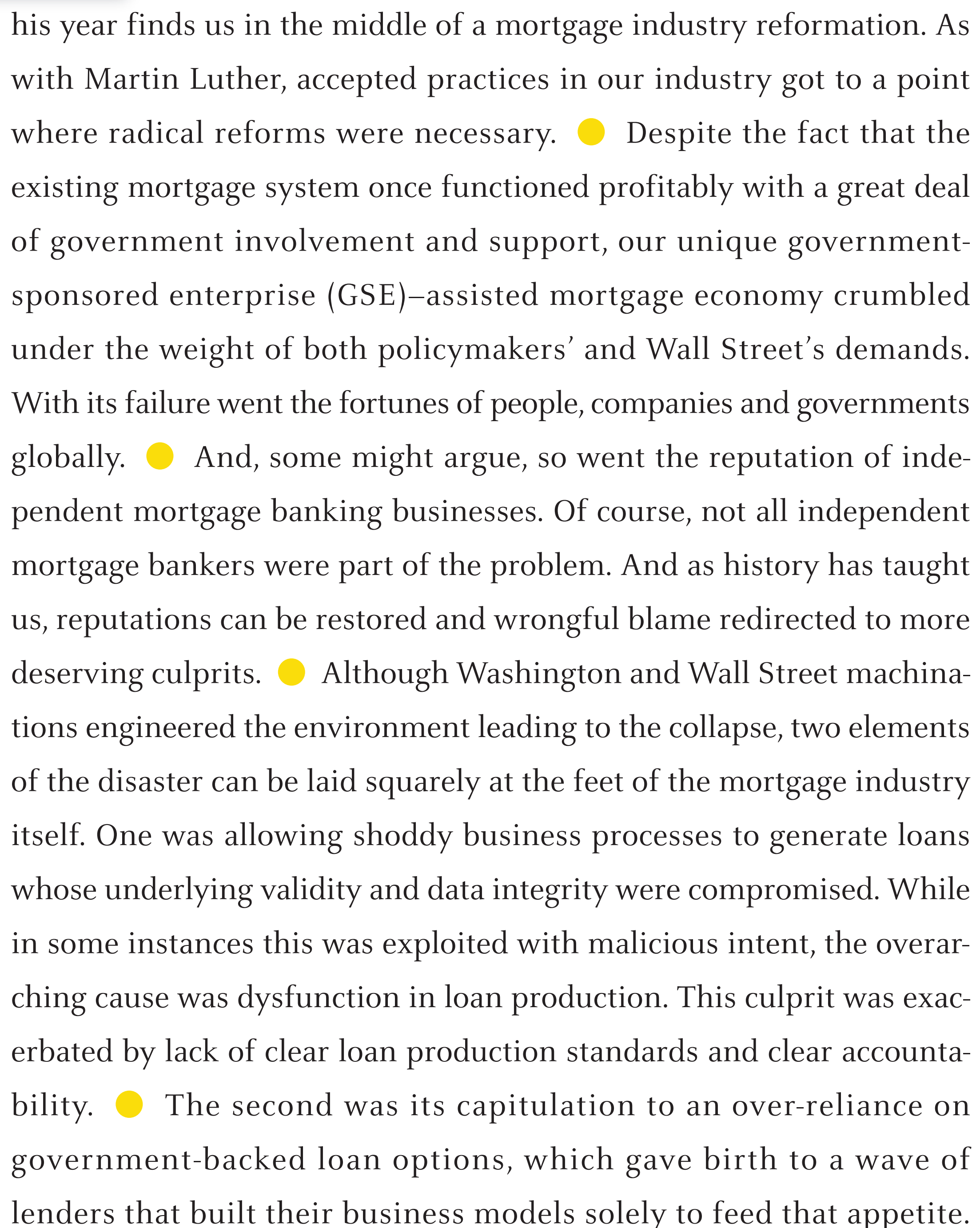

This year finds us in the middle of a mortgage industry reformation. As with Martin Luther, accepted practices in our industry got to a point where radical reforms were necessary. Despite the fact that the existing mortgage system once functioned profitably with a great deal of government involvement and support, our unique government-sponsored enterprise (GSE)–assisted mortgage economy crumbled under the weight of both policymakers' and Wall Street's demands. With its failure went the fortunes of people, companies and governments globally. And, some might argue, so went the reputation of independent mortgage banking businesses. Of course, not all independent mortgage bankers were part of the problem. And as history has taught us, reputations can be restored and wrongful blame redirected to more deserving culprits. Although Washington and Wall Street machinations engineered the environment leading to the collapse, two elements of the disaster can be laid squarely at the feet of the mortgage industry itself. One was allowing shoddy business processes to generate loans whose underlying validity and data integrity were compromised. While in some instances this was exploited with malicious intent, the overarching cause was dysfunction in loan production. This culprit was exacerbated by lack of clear loan production standards and clear accountability. The second was its capitulation to an over-reliance on government-backed loan options, which gave birth to a wave of lenders that built their business models solely to feed that appetite.

**An industry at risk**

In the years leading up to the collapse, our work habits as an industry became careless, and we erected too few barriers for opportunists to enter our profession. At our core, we are a supply chain assembling investable financial instruments. In too many cases, we fail to produce loans whose true underlying terms and conditions are accurately reflected in their recordkeeping.

These two factors go a long way in explaining why the mortgage industry reformation has taken shape the way it has over the last 12 months. First, 2010 Real Estate Settlement Procedure Act (RESPA) changes to borrower disclosure forms and processes, followed by Fannie Mae's Loan Quality Initiative (LQI), made it clear that lenders were going to be held to higher standards if they wanted to sell to the GSEs. Because GSE and Department of Housing and Urban Development (HUD) programs were the only games in town in 2009 and 2010, it looked as if loan quality was finally in vogue.

**What would be truly alarming would be opening the entire securitization market to unfettered privatization cold turkey.**

Today, policymakers are pursuing the restoration of private investment in the mortgage marketplace by seeking to gradually marginalize GSE impact on the prime market. Despite the melodrama that followed the Obama administration's release of its multi-option proposal back in February, this is not alarming. What would be truly alarming would be opening the entire securitization market to unfettered privatization cold turkey.

Courting investor confidence minus clear-cut, industrywide loan production standards heretofore represented by the GSEs (e.g., regulations/standards/automated underwriting systems [AUS]) will not build a better industry. We acknowledge that GSE support has been at times anemic and ineffectual; however, they have been the sole source of mortgage lending standardization.

Core to the industry's reformation is creating all-encompassing industry standards. As an industry we should be avidly interested in standards, because standards are at the heart of this reformation. It follows naturally that, once set, lenders and vendors will be able to more effectively manage to those standards.

In the absence of standards, we face a perpetual mess. Nature, it is said, abhors a vacuum.

Whether the GSEs will be summarily kicked to the curb (unlikely) or just cordoned off to support affordability policy and backstop crises (probable), we cannot know with certainty, and the time frame for implementation is as yet undecided. We all hope that sober, well-informed heads prevail.

**Restoring balance through private investment**

What is important, and seems most likely, according to the administration's own white paper on the subject, is moving in an orderly manner toward replacing the GSEs with private market investors.

The investment market can provide liquidity and stability for originators of high-quality prime mortgages, thereby spawning a more innovative range of appropriate products for qualified borrowers. According to a Feb. 15 *Wall Street Journal* article by Peter Wallison, senior fellow at the Washington, D.C.–based American Enterprise Institute, "More than 85 percent of U.S. homeowners have FICO® credit scores higher than 660—the dividing line between a prime and a subprime borrower."

Although the vast majority of recent production has been prime paper—some say the highest quality seen in decades—mortgage lenders have been primarily marketing residential loans to the government for the last three years. Conservatively, 90 percent of 2010 residential mortgages were government-backed (e.g., GSE, Federal Housing Administration [FHA], Department of Veterans Affairs [VA]). Rates have stayed relatively low, but we can't get any real lift in sustained volume thanks to conservative government loan limits, down-payment constraints and a complete vacuum in the private secondary market.

These are understandable boundaries to protect the U.S. taxpayer from further risk exposure. Nonetheless, our industry's recovery hinges on us being able to conduct business like businesses, not like wards of the state.

That implies doing business in a way that ensures stable, reputable, complementary investors want to buy our product. While we're not quite there yet, it is possible to imagine how that might come about.

In the absence of a seemingly rich uncle who always comes through when needed, the mortgage industry must learn how to be a real economic engine, regaining both its attractiveness to liquidity partners and the confidence of the American homebuyer.

A foundation for the path to redemption involves the industry demanding that the details be done right, giving up some of its bad business habits and embracing loan-level review.

Like the Georgia Tech researchers who announced a simple method to make concrete of unprecedented strength from crushed and reconstituted Haitian rubble, it is time for us to explore new methods to rebuild a sturdier industry from the ground up. This will start with focusing on standardization, democratizing technology and demanding clear, consistent regulation.

**Get the details right (from the start)**

On the operations side of mortgage lending, you get a much clearer view of the challenge that details represent. On the operations side working for multiple mortgage lenders of every stripe, you recognize that those problems are endemic and can be of daunting proportion.

From Titan Lenders Corp's perspective fulfilling back-office operations working with wholesalers, correspondents and investors, the problem with mortgage lending details can be reduced to the need for

standardization of process and data with transparency from origination through servicing.

Data integrity is the key. However, the industry struggles to connect its partners even as it relates to AUS data. From the originator to the settlement to the investor, there are significant milestones that can corrupt the data, such that AUS data can often be inconsistent with the closing documentation.

The competitive market environment still demands a rush to close, but the regulatory environment, with little tolerance for good-faith error, is plagued by a new expense—restitution to the borrower. This has created a huge profit sink harming lenders daily.

If even the AUS isn't sacred in the production of the final loan documents, it becomes little more than a placebo, placating the industry into believing that errors only matter when they are discovered.

Allowing your business to be haunted by unknown risk and liability has been truly vetted as a bad model, with websites dedicated to companies that now know better. We need to take an aggressive posture toward establishing standardization and rediscovering the value of disciplined loan-level review.

**Tighten up with technology**

Despite the obvious need for education, discipline and accountability at every stage of the lending operation, the industry still holds on to an "exception" mentality. Everything can be justified on an exception, but is that a good practice?

Technology has the ability to parse those decisions to their rightful owners and ensure that management understands the full scope of risk.

Historically, the mortgage industry has failed to embrace many solutions made possible by the information age. Megalenders guarded their efficiencies, and very few software solutions addressed the entire loan production cycle. Of those that do, their focus is often on a very limited scope of origination, with operations (defined as processing, underwriting, closing and post-closing) and secondary marketing an afterthought.

Indeed, the loan origination system (LOS) enables origination from application to processing, where it is pushed through AUS, but the system lacks a feedback loop to enable forecasting for the remaining steps of production and marketing. Up to this point, the mortgage production vernacular has been poorly defined, contributing to fuzzy thinking and subpar performance on details.

Spoiled by lavish cash flow, we continue to throw often-inexperienced temps at the loan production problem without embedding operational expertise through business process management (BPM) and business process automation (BPA).

That's why even today—today, a full decade into the 21st century—far too many mortgage lending operations are nowhere near fully automated loan processing. Our industry has nearly single-handedly ensured the continued relevance of manila file folders and Post-It® notes to produce these investable instruments.

Technology that binds process management and business risk decisions will define the next era in our industry. Technology that effectively manages these details is the best hope we have that the mortgage industry reformation will become the mortgage industry renaissance.

**Real-world evidence**

Real-world evidence suggests that when individual mortgage lenders recalibrate their operations with unflinching intolerance for rule bending and carelessness, problems of long-term profitability, scalability and liquidity correct themselves more often than not. That sentence is worth reading again, especially if you've been feeling overwhelmed by the magnitude of our industry's issues.

Incidentally, Titan's perspective has evolved over the last year away from one of pessimism as we see that the move to quality is under way with hundreds of mortgage bankers optimistic about their future and their role in the securitization market.

To illustrate the point, here are a few examples based on actual lender engagements that help illustrate not only the challenges but also the ingenuity of lenders in overcoming these challenges.

***Correspondent lender***

In providing pre-purchase loan review for a state Housing Finance Agency (HFA), my firm, Titan, has encountered a wide variety of correspondent lenders that are struggling through the industry's recent changes. Several recent conversations with these lenders have exposed common threads in the prime market.

Correspondents are beginning to implement new file-submission policies. They have begun to embrace the importance of quality in improving their loan submissions, lowering per-file cost and reducing their time and risk exposure while improving their industry relationship. They are often confused by what "governs" the dictates of quality, and are frustrated by a lack of clear regulatory direction.

One correspondent commented that while some requirements "are often moving targets, one thing for certain is that we have become more educated and are keeping up with the rules ourselves."

Additionally, they are looking at the quality of their operations as a means of defining their production. Many have indicated fatigue with the industry's reliance on a staff-up/staff-down response to cycle, which creates a pervasive reliance on temporary workers.

"Staff longevity is a very good indicator of a lender's ability to consistently process compliant loans. Educated processors are good for compliance and now that their certification is a requirement, the industry will experience a natural increase in quality that comes from experience and professionalism," the correspondent concluded.

This is not exclusive to processors—it is a requirement for every person in the supply chain.

### *Dual loan officer/processor broker-to-banker transition*

The industry is rife with concern about the sustainability of small-business, single-owner emerging mortgage bankers. We have a very successful relationship, a one-man broker-to-banker shop, where an energetic organized solo mortgage professional, certified both as a loan officer and a processor, has made loan quality job one. Talk about skin in the game.

He has a single warehouse line, and outsources his closing and fulfillment to close eight or nine loans a month. That's a full-time job for certain, but it is a well-paying full-time job with little residual risk of repurchase.

### *Mortgage bankers underwriting on 'conditions'*

Today, we still see lenders that are underwriting on "conditions," which is basically when the loan officer sends a loan to underwriting on borrower statements alone, with supporting documentation to be delivered.

Clearly this practice developed as a pipeline-acceleration tactic; however, under today's regulations, it provides an insupportable process flow when the documentation on those conditions is received and fails to support the program for which the loan was underwritten. As many can attest, a cascade of undesirable consequences ensues.

From compromises in data integrity to restitution, the consequences telegraph a lending operation that retains toxic vestiges of the subprime mentality, exposing it to risk of buybacks and reputational damage.

### *Mortgage bankers losing sleep over buybacks*

By the time a mortgage banker has suffered through a few painful buybacks, those still in business find that the sleepless nights drive them to solve their systemic problems.

It is not at all unusual for our relationship with mortgage bankers to become that of coach, tutor and disciplinarian. That last part is not meant to be cute. It takes discipline as much as any other single trait to transform a mortgage banking operation's engrained bad habits. And that is, regrettably, the core of our industry's issues.

Until mortgage lending businesses earn a reputation for being uncompromisingly quality-obsessed, intolerant of rule-bending and known for the most squeaky clean ethics, we will not be able to sustain adequate liquidity through private market securitization. We'll remain hobbled by our reliance on an uncle who isn't so rich anymore but still wants to govern our movements.

Boca Raton, Florida–based Choice Mortgage Bank is a retail and wholesale lender that has chosen Titan for fulfillment outsourcing, allowing it to focus on origination and its core strengths to weather the current uncertainty.

"One of the main reasons to outsource is to avoid the stress of dealing with all these changes. It provides a layer of protection," says Seth Richter, vice president, Choice Mortgage Bank.

"We may get a loan purchased, but if a question comes up later, let's just say about the docs, a lot of banks will penalize you if you can't resolve them quickly. Nobody wants to live with that hanging over their head," Richter explains.

### Giving up bad habits

For a long time, mortgage bankers have run on a cash-flow model. Because 2009 and 2010 were exceptionally profitable years for the industry, mid-tier lenders forgot the value of maximizing per-loan profit in their margins. With some hefty spikes in volume, they built hefty infrastructures with lots of overhead and managers. It offers a veneer of control until the inevitable volume drop.

Mortgage lenders seeking to retain earnings and move to the next level have to plumb every opportunity to maximize per-loan profitability. We continue to see mid-tier players that are more concerned with forcing a quick closing than they are on the bigger mortgage banking opportunity. The big guys look at each year; those who want to be big guys look at each loan.

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"From what we hear, there are folks out there trying to close loans that just won't close," says Richter. "We don't see much future in misleading and stringing clients along."

A core challenge is to learn how to scale to volume without upsetting the balance of expertise and efficiency.

### *BPM and BPA needed*

As mentioned earlier, mortgage lending needs a good dose of business process management—something the manufacturing sector and many of the service sectors embraced more than a decade ago.

BPM will lead us to a better understanding of our needs for business process automation. Like these other industries, we must learn not only to apply pragmatic research and development (R&D) to mortgage production technology development, but also to outsource intelligently to manage both quality and volume fluctuation.

Technology often does not recognize that the mortgage lending process is not linear. Rather, it more accurately reflects the global supply-chain approach that characterizes complex manufacturing today. Several things can be happening at one time in a decentralized environment. Again, the lack of standardization hobbles our industry, and nowhere more profoundly than in its need to embrace BPA.

Most industry software is weak when it comes to providing a collaborative, transparent, problem-solving environment. Pieces of problems are solved most effectively when the organic complexity of the loan is understood and visible to all participants.

Without BPM and BPA, we keep returning to a flawed business model to manage volume. Our industry discussion of scalability has advanced little in a decade.

### *Outsourcing for scalability*

Effective production is ensured either by assigning the appropriate level of staffing and expertise to mission-critical operations or electing to outsource the function to a qualified, reputable third party. As an outsourcer, we often hear the challenge from the mid-tier players that they need to "grow up" sooner or later—but retained earnings aren't realized through expenses. The megalenders use hybrid approaches to hiring and outsourcing, to great effect. For entrants looking to grow quickly, outsourcing not only delivers quick market entry and scalability, but also ensures regulatory compliance, risk management and more confident investor relationships.

Ask yourself whether your current operation is adequately staffed by experts and professionals who can respond to the current degree of change and loan-level scrutiny. What would happen if your organization had a 20 percent increase or a 20 percent decline in volume? Would you have peace of mind in the quality of your production?

Without question, the practice of rapid-fire hiring and training followed by sudden layoffs in reaction to volume is a patently bad business model that creates layers of risk. If that is your model, you'll face short-term problem after short-term problem.

### Embracing loan-level review

The current reformation is largely defined as a baseline cultural shift from "get it right if you can" to "get it right from the start." Loan-level review requires the lender to audit the entire file to ensure consistent, accurate data and its conveyance to the final documentation. We can expect that early adopters will not be alone as the chain of liability now extends along the full measure of production from originator to investor.

**Loan-level review, not just a cursory "good enough" will be a demand rather than a recommendation.**

No longer will the concept of "imbedded risk due to poor origination" be an acceptable explanation for non-compliant mortgage loans. There is little forgiveness to be found in the intolerant landscape where we find ourselves.

The industry requires a strategy to foster private-placement mortgage-backed securities (MBS). Private investors have to know—with certainty—the quality of the loans they are investing in, or they will not invest.

Loan-level review, not just a cursory "good enough" will be a demand rather than a recommendation. If investors are going to, as a matter of policy, conduct loan-level review and data-integrity checks, lenders must adopt a defensive posture via their own loan-review processes.

We propose that the industry would benefit from testing the accepted practice of sampling 10 percent of loan production or loan purchases for quality control (QC) or compliance audits. With persistent issues around non-compliant loan production, this is an industry standard that bears serious reformation.

Is it feasible for lenders/investors/servicers to perform a higher level of QC sampling? Is it feasible not to? No doubt, the current standard QC sample fails to deliver confidence in mortgage lending standards. Would 25 percent, 50 percent, 75 percent deliver better results? Reduce losses? Could increasing the percentage of loan-level review across the mortgage life cycle attract private investors? Allay regulatory concerns? Revive confidence in our industry as a whole? It is worthy of consideration.

### What we do know

Our industry became mired in the final quarter of the 20th century by innovation inertia. That inertia arose in part because of how the average mortgage lender dealt with interest-rate fluctuations. The cyclic ebb and flow of volume kept most lenders "in the moment" and did not favor operations retooling. Also, very little investment was made in true integrated automation infrastructure that offered data-integrity verification. Today, we still struggle with the term "data management" as it relates to mortgages.

We all understand that the future of a vibrant, ethical, profitable mortgage lending industry can only be realized through private investment. Still, questions persist. When will private investors return? How long will it take our industry to adapt to private investor requirements? Will small and midsized lenders survive? What kinds of innovations will emerge?

What we do know is that while legislators and regulators are devising myriad solutions, operational expertise and technology are available to support what is required immediately. While our industry needs the creative talents of its operations management, its evolution will be borne on the back of technology's response to their needs.

Typically reformation is an authentic response to a flawed system that shows no evidence of self-correction—not only risking self-destruction, but also threatening others. In that way, our current status is clearly one in reform. We have for years been constrained by a government-dominated marketplace that has had the dual effect of both imposing order and contracting opportunity.

Thankfully, the government doesn't really want to own our industry. We understand as a nation that the business of residential finance can be—is destined to be—a thriving, ethical, contributing part of America's capitalist economy. Achieving that destiny demands that we submit to the reformation and endeavor diligently for standardization, business process management and automation, disciplined zero-defect production and a sustainable balanced business model. **MB**

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