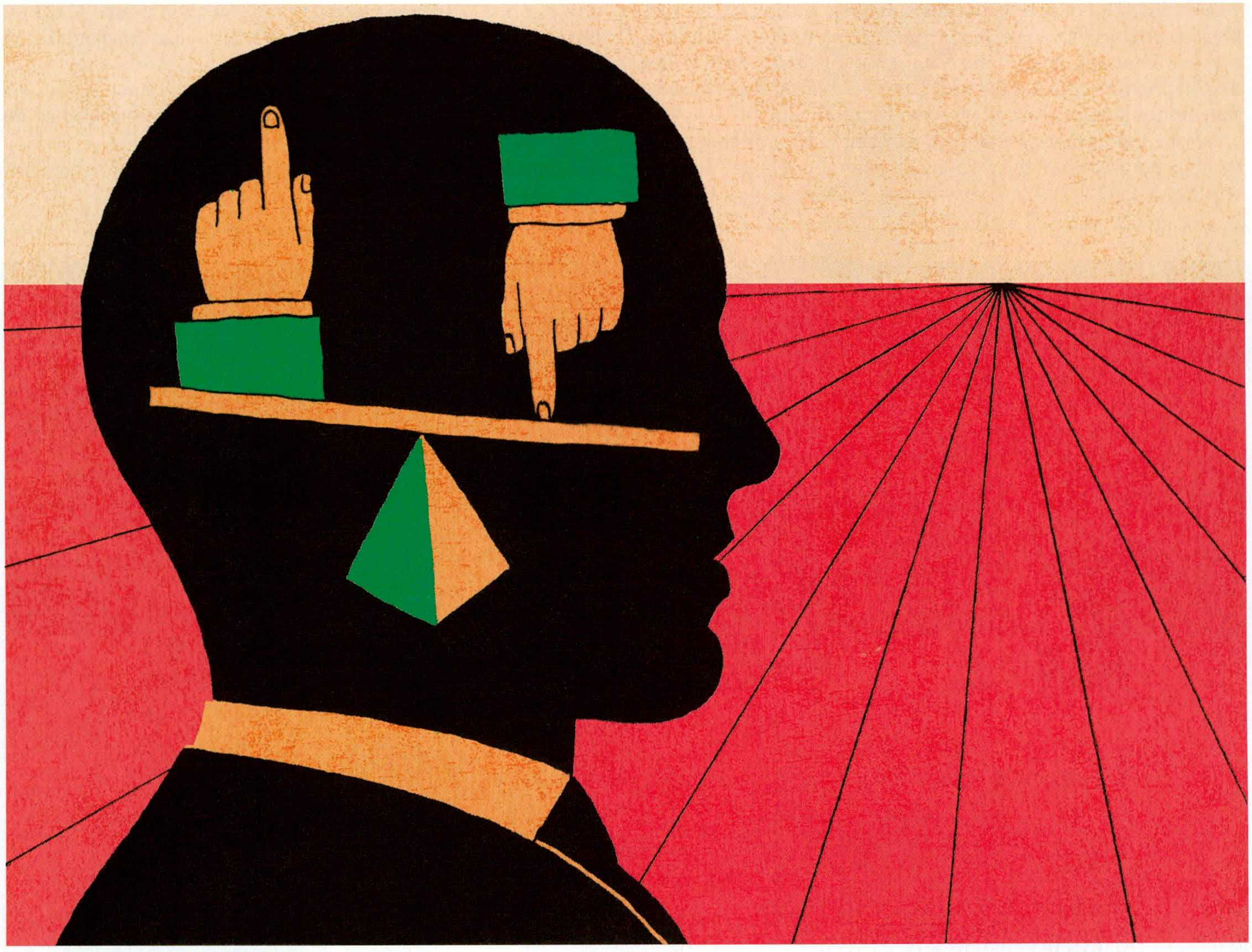
The Rebirth of **Risk Management**

— by ARJUN RAMAN —



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While past misevaluation of risk drove mortgage lenders to the brink of collapse, today risk management has become a key focus. It gives both lenders and servicers the opportunity to better understand, interpret and respond to situations. ¶ Recently industry participants have faced increased scrutiny and even fines from regulators, and are finding it challenging to keep up with the many requirements and inherent costs of managing risk. And it's not only lenders—but also ancillary companies that support lenders and servicers are expected to meet risk management obligations. ¶ In a sense, we are in the midst of the rebirth of risk management, and among the catalysts for this transformation are new rules set forth by regulatory bodies, lessons learned from past errors, and the bold initiatives and innovations of industry participants. ¶ We are at an inflection point in the history of the mortgage lending space where lenders have had to invite fresh thinking into their risk management approach to elevate the effectiveness of institutional risk management using smart process design and technology. This mortgage industry 2.0 requires a strategic and collaborative approach to preventing risk, ensuring accountability and delivering innovative new risk-based solutions.

The mortgage industry is well on its way to revolutionizing risk management.

Risk prevention is more than compliance

The Consumer Financial Protection Bureau (CFPB) plays a fundamental role in the rebirth of risk management. Since its inception in 2010, the CFPB sought to prevent the re-emergence of aggressive mortgage lending products that did not fully account for consumers' ability to understand the terms of the note or their intent to repay the debt.

A slew of requirements demand integrity in both the mortgage product and the mortgage process. The new requirements cover vendor oversight; anti-money laundering; privacy; adequate capital reserves; compliance changes such as the Truth in Lending Act (TILA)–Real Estate Settlement Procedures Act (RESPA) Integrated Disclosure (TRID) rule; or meeting Appendix Q requirements.

Through its rule-writing authority, the CFPB has sent a clear message to the mortgage lending industry: Create responsible mortgage products that provide borrowers with clear terms, transaction simplicity and borrower education. With the new rules, lenders are hyperfocused on execution timelines and document accuracy to avoid hefty fines.

> **The new risk paradigm should extend beyond mere compliance.**

But has this hyperfocused approach undermined the very essence of the Dodd-Frank Wall Street Reform and Consumer Protection Act? Are lenders getting lost in the red tape?

The other important aspect of risk management is around the detection and prevention of cyberattacks, physical security and third-party security. Lenders and servicers have a responsibility to ensure that borrowers' personal information, Social Security numbers and human resource records are protected from external threats. The question is, are lenders and servicers investing in the right technology and resources to fend off such risks?

Indeed, the new risk paradigm should extend beyond mere compliance. The real opportunity for transformation lies in the mortgage industry's willingness to allow regulation to catalyze change.

Beyond simply complying, there is a significant opportunity for the lender or servicer that invests in deconstructing core processes and reconstructing those processes to work effortlessly and efficiently with the new requirements while remembering the underlying intention of those requirements: building borrower trust.

In the past, industry participants made the fatal error of isolating risks and overlooking the larger risk story that may have revealed itself through data if viewed holistically. This tendency for mortgage businesses to wear blinders and miss the overall risk story might be its Achilles' heel.

However, the mortgage business is a people business, and risk management is everybody's responsibility and must be driven from the top of the pyramid. Businesses operating in this space will need to build a culture that embodies the essence of borrower-centric regulations despite the scrutiny, pressures, difficulties and ambiguities present in reform.

In the new culture of compliance, regulations offer the industry an opportunity to view risk strategically and re-establish empathy for the borrower. When risk is viewed in the context of related (or seemingly unrelated) factors and grounded in empathy, compliance becomes a game-changer. A strategic approach to rule implementation will allow lenders to manufacture or service high quality loans and do so in a scalable and efficient manner that builds borrower trust and is profitable. Risk prevention is not simply compliance—it is integrity.

Accountability across the board is required

In the new risk paradigm, mortgage businesses across the spectrum are now accepting higher levels of accountability. While some businesses are required to accept more accountability due to regulation, there are many that have implemented self-imposed best practices.

It is this willingness to accept accountability that suggests that the industry is maturing, and this process of maturation is of critical importance in mortgage industry 2.0.

However, in this new era of risk management, the focus on enterprise accountability may still leave gaps to be managed later down the line. The greater challenge has to do with how risks relate to one and other—the intertwining and interdependency of risks. Why is this so critical? Two words: domino effect.

Risk has always been and will always be present in the industry (physical security, information technology, regulatory, liquidity, credit, etc.), and these risks will always be studied and analyzed by experts in accordance with industry standards and thresholds. That said, businesses within the mortgage space may be too quick to rely upon analysts and economists to tell the story of mortgage industry health, and eschew the importance of their individual role in the entire process.

What good is a big-picture view when the quality is grainy? When a lender's loan data is passed down to the servicer or investor, any risks present in that loan portfolio are also passed down. Therefore, businesses across the mortgage value chain must work together to become more uniform in the approach to understanding, identifying and mitigating risks.

Reducing industry fragmentation by properly defining and assigning risks is a critical first step—risk to originators and servicers for failing to meet regulatory requirements; risk to investors for perpetuating the originator's non-adherence; and risk to borrowers for misrepresentation, data theft and risk to industry vendors for providing inadequate or unsubstantiated data, services and support in the manufacturing or selling of the loan.

That fact that more participants are individually increasing the level of accountability will ensure that their individual practices do not unnecessarily impede or negatively impact the other participants.

The industry must see who touches the loan throughout its existence, who is taking part in the process and what impact that might have on that organization individually and holistically across the life cycle of the loan. Not until organizations have fully vetted the interdependencies of risk and its impact on the entire mortgage ecosystem (and addressed compliance changes) will mortgage origination and servicing once again be seen as a viable and profitable business.

Only those organizations that can fully assess their risk today will survive the inevitable onslaught of regulatory scrutiny, and then live to fight the next battle of who can do it better, faster and cheaper.

Technology is a double-edged sword in risk management

By overlaying tangible compliance, policy and process change with empathy and a risk-based mindset and culture, the mortgage industry has successfully started altering the overall approach to risk management. As one final ingredient to resetting the risk paradigm, lenders, servicers and investors need to ensure the manufacturing or servicing of a compliant loan without compromising security, efficiency or business agility.

Having the ability to react quickly to market changes or scalability to meet program, product, rate or compliance change will determine which businesses move to the front of the line and which continue to struggle. Advances in technology are available and some are already in use; however, many in the industry are reluctant to embrace emerging trends and instead opt for a more antiquated set of technology solutions. For example, legacy homegrown core banking platforms that are not able to embrace the digital revolution and integrate with social and mobile applications will not be attractive to millennials and will end up losing market share.

> **The byproduct of recent regulation will be the removal of antiquated service providers.**

Gridlock is the term that best describes the technological environment in the mortgage industry today. On the one hand, compliance implementation has placed significant financial strain on lenders and servicers that, in turn, look to their partner technology vendors to take on some of the burden. On the other hand, recent regulation has widened the scope of lender accountability to include oversight of vendors that provide the material and mission-critical services.

To cede control of personal identifiable information (PII) to a vendor is no small risk, especially considering all of the ancillary service providers that touch and potentially take possession of that data.

Compounding these factors is the rapid development of cloud-based customer relationship management (CRM) systems, servicing systems and loan origination systems (LOS) that are gaining traction in the industry because of the efficiency gains and cost control that comes along with hosted solutions. However, the full potential of such solutions is often overshadowed by fear because the end risk of data security breaches ultimately falls on the shoulders of the lender, not the technology provider.

Today leveraging emerging technology as a tool for increased risk management can be a double-edged sword. Most technology providers are currently focused on creating technology products that fulfill the compliance and efficiency obligations of lenders and servicers, but many will not meet the requisite development requirements that will permit originators and servicers to create compliant loans.

The byproduct of recent regulation will be the removal of antiquated service providers—an act of technological Darwinism that will permit only the strong to survive in the next generation of mortgage lending.

The rebirth of risk management relies upon technology, and in many ways this represents a huge opportunity for industry disruption—even if that disruption is forced at first. The industry must find a way to bridge any disconnect between data/security risk, technology advancements and lender liability.

Beyond cloud-based systems and software, emerging trends such as big data and analytics and mobile applications present an opportunity for the mortgage industry to enhance its approach to risk management through increased data access, accuracy and risk projections.

Businesses in mortgage industry 2.0 will need to find a way to innovate and maximize the use of forward-thinking technologies despite red tape and gridlock. The end result will be a more compliant, efficient, borrower-centric and profitable lending industry.

Closing

The creation of the CFPB, the increase in cyberattacks, the downturn in the U.S. economy and the resulting contraction in the financial services market created the perfect storm for the reset of the mortgage lending risk paradigm.

The crux of this paradigm reset has been to create clear and unequivocal requirements that subject all market participants to some level of risk. From the perspective of today's mortgage originators, servicers, investors and vendors, the greatest ongoing challenge for each of the mortgage industry participants is not the increase in regulatory activity, the volume of compliance requirements or the fast-approaching deadlines. The greatest challenge has to do with how we approach, understand and manage risk interdependency.

The industry is well on its way to revolutionizing risk management, but it needs to ask new questions, approach compliance strategically and with empathy, and find ways to allay fears surrounding innovation.

Rather than asking, "What do I have to do to comply with the new regulations?," mortgage industry participants should ask, "How can I use compliance to add value to the customer experience?"

Instead of pointing fingers at vendors, partners and peers when major risks arise as a result of compounding probabilities of smaller individual risks, industry participants should proactively define and own their role as it relates to systemic risk.

Finally, rather than let risk and fear control innovation, the mortgage industry should seek out a path to disruption and look at true reform. As the famous ice hockey player Wayne Gretzky said, "I skate to where the puck is going to be, not where it has been." **MB**

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