STAYING AHEAD OF THE LAW

BY JENNIFER HARMON

All the new regulations are too much to keep up with manually, technology is required.

THERE ARE SO MANY laws that lenders have to deal with in today's tumultuous mortgage market, that it is a full-time job for lenders to keep up with all of the regulatory changes being passed on a daily basis. Outsource service providers are stepping up to the plate to help fill in the gap, tracking loans for clients and following their progress through different automated compliance systems to make sure the loans are in check with these rules.

Agoura, Calif.-based Interthinx Inc., a provider of risk mitigation and regulatory compliance tools for the mortgage industry, offers PredProtect, a feature-rich automated compliance solution, updated with every federal, state and local predatory lending law and many consumer loan laws. Within seconds, the system automatically compares individual loan data to applicable laws, warning end-users of rate and fee threshold violations, federal Truth In Lending Act violations, state consumer loan laws failures, and much more.

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—Lou Pizante, Mavent

Vice president Roger Fendelman, who oversees the PedProtect Interthinx Regulatory Compliance Suite, says a lot of different companies exist in the automated compliance space. The one thing they all have in common is that they are all working to improve their systems.

Interthinx offers a fully automated regulatory compliance check at the loan level. The company integrates its solutions with the origination processing of lenders around the country.

More and more properties are descending into foreclosure every day. It's a huge issue lenders are facing now, says Mr. Fendelman. "Lenders are doing a lot in the FHA arena and need to be up to speed on the latest regulations and guidelines."

Automated compliance can help indirectly prevent foreclosure. For many of the predatory lending laws statewide, if there is a violation borrowers can use that in defense to a foreclosure action. Borrowers can use that to stay in the house even longer.

"It costs lenders thousands of extra dollars to get borrowers out of the home and to clean up the property – to get it back in the market compared to recouping some of their losses," he said.

Automated compliance makes a difference for both larger lenders and smaller shops. Often, large companies are well staffed on the compliance side and do a lot of research on laws.

"Smaller lenders may only have one person or may not have anyone," observed Mr. Fendelman.

"They have a lot more reliance on automated compliance. Larger lenders will have less reliance on outside help to make sure they are up to date. We are seeing the technology staff for larger clients has reduced in size. Large and small lenders have this commonality to make sure their loans are in compliance."

This technology helps make the whole process more efficient for lenders to implement new law changes. "We work quickly. Lenders can't always keep up. Look at the HOEPA rule changes. Are you ready to deal with that? We actually program them into our system, so the lender runs loans through to apply the new law before they fund the loan. Lenders are subject to additional buy backs or upset investors who are tightening their compliance checks."

Most lenders have an internal legal team or they work with outside counsel and have additional resources. Interthinx believes automated compliance should not be used as a substitute for hiring a lawyer.

"They embrace what we have. We do a supplement plan for the lawyer," said Mr. Fendelman. "We work closely with them at the company law firms with the lenders we do business with."

However, he said, one thing a lawyer cannot do is look at every loan file for an hour to make sure the lender is in compliance with TILA, HOEPA or every state predatory lending law if a lender is doing thousands of loans a month.

In today's market, for many of his clients both large and small, the unifying message is that most loans originated by lenders are in compliance. Some are not.

"That sounds good on the face of it. It offers some reassurance," described Mr. Fendelman. "Loans not in compliance are expensive to correct. It can cost thousands of dollars for each loan, to buy it back, to reissue a new loan. They may have to assign new fees or lower the rate. The buyer uses this defense to foreclosure. A few numbers of bad loans could eat into a lender's profits and turn it into a loss, which can ruin a lender's bottom line. Profit margins have been stretched ultra thin right now."

He said inaccurate APR, finance charge and payment stream calculations cost lenders money as investors look for even the smallest errors to force lenders to buy back bad loans.

A bombshell recently occurred for originators when the Fed revised HOEPA rules.

"They basically fundamentally changed how business will be done. A lot of state laws are tied to the HOEPA threshold. Add to that the situation where some states have higher thresholds to help the constituents. There will be massive changes in the next six to 13 months."

It is Mr. Fendelman's prediction that there is going to be a convergence that takes place in the future. In the automated compliance sector there has not been an overnight shift where everyone switches over and does it.

"It has been a gradual change. We

have moved with deliberate speed to get there. One of the big barriers that will be reduced and eliminated is the lender's ability to provide the compliance provider with the data to do these checks."

There is a lot of data especially when the industry talks about free information to provide an accurate result. LOS and legacy document providers could not expedite it to us. That would not be a barrier through the MISMO platform, which offers a common language for passing the data.

"Lenders are begging us for the systems. Several large lenders had data in several different repositories. They knew how much programming was involved. They couldn't pull data and send it," Mr. Fendelman said.

David Zugheri, president of First Houston Mortgage Ltd, in Houston, noted the industry as a whole is coming off of an era where quite honestly lenders made loans to people who they felt could not repay.

"They thought, let me create this loan file so somebody can buy it from me. Compliance coming off of that era is kind of like re-arranging the deck furniture on the Titanic. It's about reshaping the industry as a whole and picking up the pieces. In addition to guarding against fraud and everything else, compliance is a big piece."

Mr. Zugheri recently attended a meeting at his company with regard to putting an attorney on staff. "I never thought about it in my younger years in the industry. We never had to have in-house counsel. We could comfortably afford to outsource it."

Changes are being made fast to First Houston's primary piece of technology, its LOS system. "We're putting a huge investment of money and resources into a completely new system. You can't afford not to change," he noted. "You can't originate a loan file just to minimum salability requirements. Two years ago that's what everyone did. In the third-party world, a broker shop, I know small shops that have two or three people running a version of their LOS that's five years old. There is no way they are compliant. Proper disclosures are not coming out."

With a more robust engine behind it, the company's new LOS will provide initial disclosures upfront to the borrower. The company will extract data from its LOS and send it to the law firm.

"This all happens electronically. They send us back all the current disclosures to keep us compliant. It's very likely we will roll that out within 45 days. That is all automated – the data feed. It is taken from our system to the law firm's website. To send every one of the files through a compliance disclosure engine is about $8 to $10. All of that means is a higher cost of credit that ultimately would be passed down to the consumer and taken into the margins."

If it was up to him, Mr. Zugheri would automate as much as possible. "But when it comes to certain pieces, the whale of compliance is all about licensing. I need to have a piece of software that can monitor it all and tells me when loan officers' registrations expire. Our new LOS has that function."

Midsized lenders are caught between a rock and a hard place he says. Mom-and-pop shops can barely afford to outsource any legal work and most large lenders have a legal staff. "Middle people have to come to the table and make that hard decision – to put a lot of money into an LOS that will make them compliant or put a lot money into each file to send them to a law firm before it goes out to make sure it's compliant."

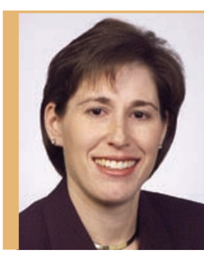
Lenders operate in an environment of multiple systems. What is at one office may not be the same information at the title company's system, Mr. Zugheri pointed out. "If someone at the closing table makes a mistake, I'm no longer compliant. Automation will not catch everything. It doesn't mean we don't need to make the investment. We all do. Really, 100% automated compliance is definitely mortgage blue sky."

Sometimes there are too many different entities putting their hands on a file. "I rely on the title company to be compliant and make sure they sign all the documents," he says. "Compliance nirvana is attained through multiple parties doing their job. We have a bar-coded system when the documents come back to the office. So we instantly know if documents are missing something."

According to Nanci Weissgold, a partner with the Washington law firm K&L Gates, more legislation is being passed that extends the timeline for foreclosure and other servicing related items. "Loss mitigation – servicing is where it's at," she says. "It's an area of the law in mortgage lending that has been a gray area traditionally. The origination side was more heavily regulated. That's finally changing."

Her firm does a great deal of state law tracking. The number of states with servicer licensing and registration is growing. This is happening in places like North Carolina, New Jersey, New York and California.

"States are under a lot of pressure to



States are under a lot of pressure to try to keep borrowers in their homes as long as possible.

—Nanci Weissgold, K&L Gates

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800-333-4510 www.interthinx.com sales@interthinx.com try to keep borrowers in their homes as long as possible, to come up with solutions to help them stay there. State laws are enacted for foreclosure, requiring more notice and more borrower contact."

It is overwhelming for lenders and servicers to try to keep up with these changes, she says. "It is a crisis. A lot of emergency measures are being passed which take effect immediately. The consequences are significant for violations. Lenders have to make sure they are up to speed and implement procedures. They need some sort of update service to keep them informed. People don't want to make mistakes. So much is happening it's harder to dot the i's and cross the t's."

Lou Pizante, the CEO of Mavent, located in Irvine, Calif., compares the current foreclosure epidemic to that of a terminally ill patient with cancer and a gunshot wound.

"Foreclosure technology and its processes are trying to stitch up the bullet hole, but the problem is you have to treat the cancer if the patient is going to live," he says. "You have to make sure lenders comply with all the consumer protection laws out there so these sort of situations don't happen in the future."

Interest rate charges, additional fees, and the borrower's ability to repay a loan are all related to underwriting and foreclosure. The industry has been struggling, as performance has been dismal, he says.

"Now lenders are taking a much harder look at these loans. They use a system like ours before they make the loan. Often, they did it after the loan closed. They used backend quality assurance vs. front-end quality compliance."

Mavent's automated compliance solutions include the Mavent Expert System, the Mavent Compliance Console, custom-client automated compliance engines, and its lender and broker license verification and monitoring service. Mavent analyzes electronic loan data to determine whether a loan complies with more than 300 federal and state consumer protection laws related to mortgage lending.

Before, most lenders were using automated compliance engines on a sampling basis. Federally regulated institutions with prime products were found to have 83% violations. The adverse economic impact that non-compliant loans can have on a lender's business, including regulatory fines and penalties and class-action litigation for consumer protection violations, is huge.

"Inarguably, the industry has failed to get compliance right," Mr. Pizante pointed out. "They really haven't leveraged automated compliance programs for today's market. The mortgage industry has been resourceful on how to apply technology to use credit risk, the borrower's ability to repay, collateral risk, or interest rate risk. They have been resourceful on the leverage automated valuation engines and interest rate hedging models to cost effectively manage these risks and not slow down production. But compliance, instead of changing their ways, funding and purchasing compliant products, they kept the backend quality control method carried over from much simpler time from the S&L days. They need to make sure it's done in the front end and make sure the loan is compliant at the beginning."

Lenders have lost public confidence following the scrutiny from regulators. "Defaults change everything. As soon as there is a notice of foreclosure, the lenders see issues on certain loans and they start seeing lawsuits. The lawsuits are mounting against them. New class actions are being filed each day."

Lenders have to do a better job to comply with consumer protection laws, Mr. Pizante stresses. "With backend quality assurance, the lender might have good intentions, but that won't appease regulators or plaintiffs. Review every loan before funding or purchase to make sure you comply."

Consumer credit attorneys are often responsible for maintaining different rules. Mavent canvasses the entire county in its decisioning engine. Mavent's compliance rules are maintained by its in-house attorneys in coordination within its network of nationally recognized law firms.

Down the pike, regulators could get even more aggressive. The bold new rules to Regulation Z and Truth in Lending apply to a significant number of loans. "We're just at the very beginning. Regulators and lawmakers are concerned about foreclosure. The bullet needs to get stitched up, but we need to deal with the broader sickness and heal the cancer."

"If you have a smart compliance system program, one that intelligently leverages technology and is front-end oriented, it will allow you to manage compliance risk on a variable-cost basis, then there is no reason to pull out. Your compliance program will enable you to grow and offer new products in new markets. As compliance and underwriting become more and more intertwined, strong automated compliance program is going to be the differentiating factor," concluded Mr. Pizante. MT

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—David Zugheri, First Houston Mortgage