CoverStory

DIALING DOWN RISK

As lenders realize that they have to better manage their risk, technology comes more into play.

BEFORE THE MARKET DECLINE RISK MITIGATION was controlled in-house, but now it has become such an issue that lenders can't do it on their own. As a result, lenders are reaching out to vendors that specialize in different areas of risk mitigation to restore confidence in the loans still being originated. Left to right: Lou Pizante, CEO at automated compliance detection vendor Mavent; David Colwell, EVP at decisioning and analytics vendor Loan-Score Decisioning; Steve Daniels, SVP, mortgage banking director at what was Wachovia, now Wells Fargo; Bruno Trimouille, market development director, financial services at business rules automation vendor ILOG, which was recently acquired by IBM; and Mark Phlieger, CEO at loan origination system vendor Avista Solutions, talked with our editor Tony Garritano about how lenders can put together a bullet-proof risk mitigation strategy.

Photography By Gary Laufman

MORTGAGE TECHNOLOGY: *If a lender was in front of you and told you, "I need to better handle my risk," what would you tell them? And from the lender's perspective, what are you looking for in a risk mitigation strategy?*

BRUNO TRIMOUILLE: On our end, we come into play when the lender figures out from a high level what they want to do as far as the different policies and the different checkpoints they want to enforce. When these policies are being documented or formulated in some English-like statements then we capture those best practices, and automate those best practices against some kind of data feed whether live or batch, and then render the results.

DAVID COLWELL: From our standpoint, risk mitigation has really three different facets. The first is if you look at most lenders on the very front end, risk mitigation really needs to start at the point-of-sale and it needs to start with accurately determining the detailed underwriting guidelines that you're going to utilize to underwrite that product. So, risk mitigation starts with the utilization of a detailed, accurate underwriting engine that can look at and break out a detailed view of credit and utilize that to get as granular as needed. Now, risk mitigation throughout the lifecycle of the loan or the life of the loan as I like to call it, you have risk mitigation from a compliance perspective where you would then automate the policies, procedures and guidelines from a compliance perspective to make sure that you dotted the i's and crossed the t's, so to speak to make sure that (a) on the front end you bought the right loan or you underwrote to the investors' guidelines correctly; but also (b) as you manufacture the loan you are able to utilize policies and procedures and you've manufactured it "the right way." The final piece of risk mitigation is in the post-closing component or the portfolio analysis component where you go back periodically and utilize a rules engine to make sure that the way the loan is being serviced today follows the way the loan was both underwritten and originated.

MARK PHLIEGER: You've got to have a product that's out there on the street at the point-of-sale. Whether you're using your own in-house AUS or you're using an external AUS, you've got to have the ability to bring all the pieces into one. By that I mean the ability to have your loan origination data, your underwriting data, etc., in one place, and you've got to be able to validate those against each other as they move through the process. You've got to be integrated with tools like Mavent to have the compliance piece of things covered.

LOU PIZANTE: The cost of risk mitigation and risk management is exploding. At the same time, even though institutions are spending more than ever on trying to manage their risk, the existing systems and processes have been found wanting in several respects. The industry is going to evolve radically over the next several years and that's going to force even more investment in technologies that automate risk. One thing that I think is absolutely critical is top-down sponsorship, management championing reevaluation of the way business is done and the way systems are implemented.

STEVE DANIELS: I don't think there's a lender out there that thinks they have bad risk policies. I think we've all seen opportunities now for improvement.

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—Bruno Trimouille, ILOG

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—David Colwell, Loan-Score Decisioning

When looking at a vendor or a partner in terms of risk, what you're looking for is end-to-end functionality, someone that can interpret that risk into either credit, market and/or operational risk. You also want a tool or a product that's proactive, something that's going to alert you and say, "Hey, we have an increasing amount of risk in this area." It's not something you want to go hunting for. We know as fast as loans get made today that if you have a bad policy or a bad procedure and you're just doing more of those faster, well then it's harder to go back and actually look at it. When you're looking at a vendor you also want to see what they bring in terms of best practices.

MORTGAGE TECHNOLOGY: *A big component of any risk mitigation strategy has to include come kind of fraud detection. What's your opinion on fraud detection, fraud detection automation and how it should be used?*

BRUNO TRIMOUILLE: Fraud has so many different dimensions. For example, you have a database for your address matching, you have a database for broker licensing, etc. You have so many different techniques and providers in a database that maybe it's a bit hard to know where to start. Lenders are going to say, "Well, where can I get the biggest bang for the buck in terms of catching most of it?"

DAVID COLWELL: I just don't think lenders have really figured out how to map out what their risk mitigation process looks like. Lenders have to peel that onion back and say, "Well, what are the aspects of fraud detection that are the most important to touch on?" Because I have seen some fraud detection tools that, my God, you could get lost in them. I mean, you could. So I think mapping out the process of risk mitigation of which fraud detection is one important aspect of it and then

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peeling back the onion of fraud detection and saying what does that subprocess look like will enable lenders to identify which fraud detection tools to use. From what I see, lenders just haven't gone to that level of detail.

LOU PIZANTE: There's certainly fraud providers that have elements of regulatory compliance built in and I think the two areas are complementary because often the same personnel in an institution are responsible both for fraud and for consumer protection compliance. I think that there's been so much change over the past decade in our industry the shift from this portfolio lending to a more securitization model, from retail to more wholesale, product proliferation and there's also been a change in the technologies that are available, the information that's available, and the types of fraud that can be perpetrated as well. We don't have enough historical data really to be able to understand what risks are out there.

MARK PHLIEGER: In our space, in that $100 million to $5 billion a year in originations, they are typically relying on outside vendors. So we've got to make sure that we've got the integrations there and we're collecting the right data for that vendor. For us, FraudGUARD from Interthinx is one of the ones we offer and the other one is CBC's DataVerify. We've got to make sure that we've got that data on the broker, that data on the LO, that data on the borrower, that data on the property and that we can supply that to the vendor that specializes in that area. We supply it to them at the point-of-origination via XML. They return a response that we can allow that lender to act off of. I'm sure there is an expense to dealing with multiple vendors here, but lenders are serious about catching fraud.

MORTGAGE TECHNOLOGY: *But was that always the case? Were lenders as concerned about fraud as they should have been during the boom days when volume was coming in left and right?*

STEVE DANIELS: I don't know that you'll find a lending institution saying, "We're willing to accept fraud so we can get more volume." I also wouldn't say that subprime borrowers are more apt to be fraudulent than prime borrowers. Again, you have to look at the fact that there are so many different aspects of fraud. Again, you've got appraisers that are appraising all of the above; you've got loan officers that are doing all of the above; you have shell borrowers. I mean you have so many different fraud schemes that are out there and you see those on A paper, B paper, C paper. It doesn't matter. And you see it all the way around. Once fraudsters find that hole they'll maximize how many loans get through that one area. I'd just be cautious making a statement that we're overlooking fraud for volume. Obviously a lot of fraud was going on. I think we'll all learn from that moving forward, collectively as an industry, and not just as one lender or two lenders. Going forward, I think a lot of the customer advocacy groups that are out there, a lot of the government regulation, a lot of that, whether we're nationalizing databases for loan officers or brokers or whatever the case may be, that is going to take a large part of fraud out of the mortgage process.

MARK PHLIEGER: It's kind of funny. I was just thinking about what Steve was saying and it reminded me of something I'd heard a long time ago and you guys have probably heard this too. I think it was Reagan that said it. Reagan always said trust, but verify. Maybe we can apply some foreign relations tips to loan originations here. You wan to trust your partners, you want to trust your borrowers, but you've got to verify everything. You can't depend on just trust.

BRUNO TRIMOUILLE: To come back to Steve's point, some of the due diligence that sometimes may be put under the fraud umbrella is really just about collecting more data and being more astute. What I mean is you need to both collect a lot of data and be more granular in how you use and look at that data. You need to get the full picture. The fraud umbrella involves a lot of due diligence in collecting data, so we come back to a decision that is very accurate in getting the full picture from a credit standpoint.

LOU PIZANTE: The issue is bigger than fraud. It's quality. I don't think that the industry willfully ignored the risk associated with fraud or other risks, but I do think that if you look at the compensation structure within the industry it incentivizes production, it doesn't incentivize quality, especially if you look at loan officers and brokers. They get paid based on production and they get essentially a lump sum payment based on closing a loan. None of their compensation is tied to the life of that asset and the quality of that asset, or even the performance of that asset over time. Ultimately when you create a compensation structure that incentivizes just upfront production you're going to pit your production people against your risk people and more times than not your production people are going to win that argument, especially when you're in an environment where there's many financing options.

DAVID COLWELL: That's a very good point. I actually heard a couple of lenders, some big ones, talking about changing the compensation model for loan officers where they keep their solid, good, high-quality, conscientious loan officers, and pay them a higher base, but their commissions are paid when the bank gets paid. There's some discussion in the industry, and I think it dovetails with what Lou said, to pay originators based on collected revenue and not just on closed loans.

MORTGAGE TECHNOLOGY: *Another part of risk is compliance. Compliance is going to become even more complex come January when we get a new president. What do lenders need to know in terms of how to monitor compliance electronically in an environment that's very dynamic?*

LOU PIZANTE: There are several trends around the regulatory environment right now that lenders should be aware of. Two that I think are important to note are that we're seeing the introduction of and proliferation of a new breed of laws that are similar to predatory lending or high-cost laws that we saw in the earlier part of this decade. But the thresholds or the applicability of these laws apply to a much broader segment of loans. More products than previous are going to be regulated both at the federal level and at the state level. The second thing that is going to be a big concern is fair lending laws. The laws we saw a generation ago really focused on the pattern or practice by the lender. So, if you could prove some sort of discrimination, or unfair lending, or that an unfair and deceptive act was performed on several loans in a pattern, then the institution could be fined, the borrower would have a right of action. What we're seeing now though is more of a strict liability type of approach where a single violation, a single compliance exception is a violation of law that can give rise to regulatory fines, or penalties, or to class action lawsuits.

STEVE DANIELS: I agree totally with Lou. As a result, it can't be done manually anymore. I mean we're drinking from the fire hose on regulatory changes and compliance changes and it's just going to get worse. MT

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—Mark Phlieger, Avista Solutions