Clamping Down on Non-Compliance Efficiently

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Increasingly, lawmakers are saying that the secondary market is guilty of "compliance apathy." Assignee liability, which essentially makes the purchaser of a mortgage loan liable for mistakes made by others, is their weapon of choice. It more or less attempts to create a de facto police force for the secondary market.

Whether or not this is fair to investors, it is arguably an elegant tactic for resource poor regulators to better coerce compliance. The lawmakers' point is that the secondary market investors in effect, if not in actual fact, control primary market behavior. Presumably then, assignee liability ensures that those ultimately in control have acute motives for ensuring a compliant industry.

In the rationale for assignee liability three main deterrents to investors stand out.

The first is simple to quantify: investors are exposed to losses from assignee liability arising from fines, penalties and civil awards. In some cases, the loss potential is substantial.

TILA, perhaps the most deeply rooted consumer credit regulation, provides a helpful example. A mistake in disclosures may extend the rescission period. If the normal three-day rescission period does not end as expected because of a mistake, it continues for three years. This means the borrower has the loan funds, but at any time during the three-year extended rescission period he or she may decide to reject the loan.

Borrowers often only find out the creditor made a TILA mistake when they fall behind on payments, face collection or foreclosure actions. Oftentimes, these same borrowers seek bankruptcy protections. If the mortgage is rescinded, the mortgage loan may essentially become an unsecured obligation of the debtor in bankruptcy, subject to satisfaction at pennies on the dollar or, worse still, discharge.

This example is particularly relevant today. Responding to competitive pressures, lenders are creating a host of products with innovative terms, features and payment streams. Presumably some lenders' and investors' compliance controls have not kept pace with product innovation. Consider this in light of the expectation that, in a less benign rate environment, many borrowers will be challenged to refinance out of a these so-called "exotic" loans. As Warren Buffett said: "When the tide goes out, we'll see who's wearing bathing suits." non-compliance issue. It is not uncommon for scratch and dent pools to trade at significant discounts (i.e., 10-20 basis points) to readily saleable assets. At a minimum, the loan would have to be marked down by the cost associated with the remediation of the violation and arguably a liquidity premium as well.

Consequently, lenders and investors that do not work together to ensure loans are compliant at funding run the risk of finding themselves in an adversarial relationship. Eventually, if recurring, this will compel either party to seek out a partner that is able to provide higher quality product or better transaction execution.

The third deterrent is the most difficult to quantify: reputational risk. There have been sufficient headlines lately that no more needs to be said.

So, given all this, what are the tactical responses available to mortgage institutions? Quite simply, regulatory complexity and existing technology make compliance systems a business requirement. Such systems efficiently and cost-effectively ensure that loans are funded and purchased in accordance with applicable law. Unfortunately, this apparently straightforward solution turns out to be harder to execute than one might suppose. There are two broad issues.

The first is measuring return on investment. This is a slippery calculation because nobody likes tracking, much less documenting, non-compliance costs. While the return on investment of deploying automated compliance solutions will vary across institutions, suitable solutions exist for all lenders and investors to realize common areas of significant savings.

Lenders can redeploy compliance staff, eliminate potential or existing regulatory penalties or fines, realize improved secondary executions, and in some cases enhance asset cash flow characteristics with no increased risk. For investors, the savings are also significant. In addition to mitigating the abovementioned risks, reviewing all loans provides for a more complete picture of loan data prior to purchase. This ensures the purchase of quality loan pools. It also allows investors to better evaluate the profitability of its relationships by identifying lenders with poor quality controls in place.

The second issue is settling on whether to develop and maintain an in-house solution or leverage a third party service. Clearly, the investment of an in-house solution is significant. Smaller institutions that lack the required sophistication and resources internally are best advised to outsource a system. But even larger institutions that possess ample capability must soberly consider the wisdom of maintaining a proprietary compliance system. As the lending environment becomes increasingly competitive and industry regulation grows ever more complex, maintaining an in-house compliance system will require more and more cross-functional resources. Considering the importance of execution speed to profitability, few smart managers will agree to place automated compliance among the institution's core competencies.

Institutions that choose to use a third party provider must evaluate the quality of the service. Automated compliance can be as hazardous as it is beneficial. Inaccurate rules yield costly mistakes, quickly and consistently. Institutions that presume that compliance systems are a commodity will eventually be unhappily enlightened.

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In the next issue The Turning Point will discuss the best way to automate customer relationship management.