Mortgage Technology's

State regulators accelerate to warp speed with an automated solution for examinations.

BY
JOHN VONG

Technology has changed the front office, the back office—even the secondary marketing aspect of residential mortgage finance. Now it is about to rework its magic on what just may be the final frontier: government regulation. ● This month, a new era in mortgage lending oversight will arrive when 10 states go live with an automated system that is more comprehensive than any manual examination process, yet will be less costly, more expedient and—perhaps most important—more objective and uniform. ● Under a nationwide cooperative agreement for mortgage supervision adopted by the American Association of Residential Mortgage Regulators (AARMR) and the Conference of State Bank Supervisors (CSBS), both based in Washington, D.C., state banking and mortgage examiners will conduct audits of loan-level information transferred electronically from lenders and servicers, using Web-based software to determine whether the transactions are in compliance with the numerous federal, state and local requirements. ● The automated auditing system will then generate an "Examination Dashboard" report that can easily be reviewed by examiners. If no violations are found, the state-regulated institution receives a clean bill of health. But if the audit reveals violations or exceptions, the examiner can initiate a more thorough, even more targeted, investigation. ● "This initiative will dramatically improve mortgage regulation, with faster and more comprehensive examinations," says AARMR President David Bleicken, the director of licensing, investigation and consumer services in Pennsylvania's Department of Banking. "We are always trying to improve upon what we do, and this proves the states continue to be in the forefront of regulatory innovation."

FINAL FRONTIER

The improved efficiency of the technology-based approach can be expected to tangibly reduce the time and expense of audits, for both regulators and the companies they oversee. But saving time and money is only one benefit. Standardization will be another result—not only among the various state agencies, but also among lenders and servicers licensed in more than one jurisdiction. In fact, the same automated compliance technology that regulators have adopted has been widely used by financial institutions of all shapes and sizes for several years.

As you might imagine, institutions already using compliance technology tools on a regular basis will have a pretty good idea of what their examination results will look like even before an audit begins. In another context, it could be called an "open-book test," or maybe even "cheating on your exam." But in the regulatory arena, it's called "self-examination," and it's not just allowed—it's encouraged.

The 10 states that will bring the new examination program to life are California, Connecticut, Indiana, Louisiana, Michigan, Nevada, North Carolina, Pennsylvania, Washington and Wyoming. But eventually, all 50 states and the District of Columbia are expected to sign on to the initiative.

Nationwide adoption couldn't come at a better time. At ComplianceEase®, a division of Burlingame, California–based LogicEase Solutions Inc., our daily monitoring of the mortgage compliance landscape is telling us that a stricter regulatory environment is on the horizon as one of the many responses to the current mortgage crisis. And we are not alone in that thinking. Says CSBS President and Chief Executive Officer Neal Milner, "To ensure the safety and soundness of state-regulated financial institutions, we are working together across state lines to improve regulatory enforcement and oversight. By leveraging the latest technology to supervise and examine institutions in a more seamless, more flexible and more risk-focused fashion, we can continually improve consumer protection."

'Overnight' success

As usual with breakthroughs of this sort, this one didn't happen overnight. Indeed, it was more than four years ago, in the summer of 2004, when Chuck Cross—then acting director of the consumer services division in the state of Washington's Department of Financial Institutions—first described what he envisioned as a universal system by which examiners could look at lenders that operate within their jurisdictions.

As he saw it at the time, the system he dubbed CAUSEWAY—a mouthful of an acronym that stood for Combined Analysis Using Software and Examinations to Winnow and Yield—would be a method by which lenders could more efficiently deal with routine exams. It also would allow enforcement officers to zero in on problem loans more effectively. "It's a new way of sifting the wheat from the chaff and getting down to the real issues," Cross said back in 2004. "We're working on it in Washington state, but in no way do we want to keep it to ourselves."

Cross, who became president of AARMR in 2005, recognized that examiners needed to find a way to stretch their ever-dwindling resources over an ever-growing mortgage business.

He knew that the "sample and review" method of examination common in most jurisdictions is not an issue when the lender under scrutiny originates only a few hundred loans a year. But when the lender has churned out thousands of loans since the last regulatory checkup, examiners often end up "spinning their wheels and spending lots of time and money looking at non-issues," Cross says.

Eventually, the CAUSEWAY acronym fell by the wayside—but not Cross' passion for a better method for conducting routine audits. "The traditional way of doing exams wasn't working for me anymore," he says.

"To me, it was like looking for a needle in a haystack. Umpteen years ago, examiners were taught to look at a percentage of the institution's loans. But if only 5 percent of the portfolio has problems, what are the chances that you'd pick up any of them? We needed to get exponentially more efficient at what we were doing, at a time when we were having to do more with less and when loans were becoming more and more complicated," he says.

Cross calls traditional examination guidelines "a hit-or-miss approach," and says too many bad things were happening in the market that were never caught. At the same time, he also concedes, not every company was a bad apple or needed as much scrutiny as others might require.

Model examination process

AARMR, a forum for state mortgage regulators to exchange information and ideas, didn't have the resources to pursue Cross' idea. But CSBS, the 107-year-old trade group for banking regulators in all 50 states, did.

So in mid-2007, in the wake of the mortgage meltdown and the subsequent credit crisis, AARMR and CSBS came up with model examination guidelines (MEGs) in an effort to provide consistency and uniformity in the mortgage audit process. The MEGs, as the organizations called them, comprised five different modules, the fifth of which called for the adoption of a technology solution that would help expedite regulatory examinations by verifying loans against numerous federal, state and municipal laws and regulations, including, but not limited to, predatory lending ordinances, consumer credit laws and even the Truth in Lending Act.

In mid-2007, in the wake of the mortgage meltdown and the subsequent credit crisis, AARMR and CSBS came up with model examination guidelines in an effort to provide consistency and uniformity in the mortgage audit process.

Initially, CSBS, where Cross now hangs his hat as vice president of mortgage regulatory policy, began developing a simplistic spreadsheet tool to assist testing for the accuracy of annual percentage rate (APR) calculations. But that idea was jettisoned when CSBS learned that several independent software vendors could provide sophisticated programs capable of testing loan transactions for a host of regulatory compliance issues.

A nine-state task force was assembled to test the available software—California, Connecticut, Illinois, Indiana, Massachusetts, Michigan, Pennsylvania, Washington and Wyoming. Examiners in each state rated the programs on 34 questions in five broad categories, including federal compliance, state compliance, usability and customer support. The evaluation period lasted eight months, but the bulk of the testing took place between December 2007 and February 2008.

It was at about that point, in March 2008, when technology providers made their formal presentations to the CSBS Technology Committee. Michael Chan, vice president at ComplianceEase and head of state regulatory initiatives, recalls, "Many challenges surfaced as we went through the evaluation process with the task force. Based on our experience with the industry's adoption of ComplianceAnalyzer® and acceptance of automated compliance in general, we knew that there would be a learning curve and even a certain amount of apprehension as to how technology might impact the long-standing processes with which regulators were accustomed."

All three automated compliance providers whose products were tested received a significant number of positive ratings. Indeed, a recommendation report from CSBS noted that, "Given the quality and sophistication of all the programs and the substantive customer support provided by each vendor, the states could be well-served by the selection of any of the providers." In the end, however, CSBS selected ComplianceEase's Web-based software, ComplianceAnalyzer.

"Both the numerical and subjective ratings weighed" in ComplianceEase's favor, the CSBS report stated.

"ComplianceEase has helped us achieve a very specific goal," Cross said in announcing the choice of our company. "This has far-reaching implications for the way regulators and financial institutions will approach what has been a time-consuming and cost-prohibitive process. Technology and automated solutions have become essential elements in standardizing and improving regulatory supervision while streamlining the examination process for institutions and for regulators."

While just 10 states have adopted the model examination guidelines so far, the guidelines are now available for use by all jurisdictions, and nationwide adoption is all but a forgone conclusion.

AARMR and CSBS have been busy educating their respective memberships about the MEGs initiatives through a series of panel sessions at meetings and conferences. In addition, a segment on how to use the software has been incorporated into the curriculum of the Advanced Residential Mortgage Examination School offered by CSBS to regulators and financial institutions.

"The first impression of ComplianceAnalyzer by many regulators and examiners was one of both cautious intrigue and enthusiasm," Chan says of the initial training sessions. "I believe many of them thought it would be traditional software that you have to install on your computer from a CD, rather than a Web-based application that could be accessed directly from the Internet. In the end, wariness gave way to a kind of kid-in-a-candy-store excitement as participants began to recognize that what was being offered was an entirely new way to conduct mortgage examinations."

How it works

In the examination model adopted by AARMR and CSBS, our patented ComplianceAnalyzer system forms the heart of a robust, Statement on Auditing Standards (SAS) 70 Type II audited examination platform, providing baseline regulatory as well as customized, regulator-specific audits.

ComplianceAnalyzer is well known in the mortgage industry for delivering loan-level compliance analytics through a software as a service (SaaS) model, enabling companies to be certain that loans adhere to the various rules and regulations in just a fraction of the time it would take for a traditional review, and at a fraction of the cost. In fact, in selecting ComplianceAnalyzer, AARMR and CSBS regulators join a community of more than 6,000 ComplianceAnalyzer users that includes four of the country's top-five mortgage companies, as well as more than 250 other institutions and service providers.

In the system adopted by AARMR and CSBS, two new product releases—RegulatorConnect™ and Regulator Direct™—also will play a big part in the process. Examiners will use the ComplianceAnalyzer system to drill down on the specific areas on which they need to focus without ever having to leave their offices. Meanwhile, RegulatorConnect will be offered to all state-licensed lenders and servicers to assist in exporting the required data from their origination or servicing systems, linking them to state regulators through electronic data transfer for the first time. RegulatorDirect will enable ComplianceEase's own customers to electronically deliver compliance audit reports to regulators with a single click.

The key to making a technology project like this a success is extracting accurate electronic loan data from lenders' and servicers' systems. With this in mind, we devised a partnership program with other technology platform providers to help ensure that lenders won't need to expend resources developing their own loan data export capabilities.

To date, more than half of ComplianceEase's 30 technology partners have signed up for our new RegulatorConnect certification program, in which our partners will build export functionality directly into their systems and platforms specifically to facilitate the new automated exam process.

"The system fits right into our *modus operandi,* which is to do as much as possible electronically," says Sig Anderman, chief executive officer of Ellie Mae Inc., Pleasanton, California, which is fully integrating RegulatorConnect support into its Encompass® loan origination software. Encompass has about 10,000 mortgage broker, mortgage banker and bank clients, many of which "could really use a program like this," says Anderman. "To be part of the solution, clean lending starts here."

Whatever the means used to export it, regulators will receive the data for each loan electronically. And in a matter of seconds, every loan will be run through ComplianceAnalyzer's comprehensive set of tests. The system will then return a concise, yet thorough, analysis of problem areas and apparent violations for each and every loan.

Thanks to automated auditing, for state regulators, worrying about examination capacity will be a thing of the past. There is absolutely no limitation on the size of the portfolio that can be audited. Once files are in the examiner's computer, the system can audit them at the rate of two seconds per file.

Consequently, a portfolio of 1,000 loans can be reviewed in roughly half an hour. Indeed, capacity is a not an issue. Nor is the number of tests each loan is put through. As compliance officers well know, while federal laws are the same in every state, not every state has the same rules. Depending on the jurisdiction, there might be as many as 300 tests—and ComplianceAnalyzer tests for all of them.

Targeted reviews

In the "olden days," a team of examiners looking at a large portfolio of 10,000 loans would select a sample of, say, 1,000 for a complete, loan-level review. Hopefully, the sample represented the population of the portfolio as a whole, but there was no way to be certain that was the case.

Now, say that 200 of the reviewed loans had serious problems that needed to be addressed. That's 20 percent of the sample. If the sample was truly representative of the entire portfolio, then it could be extrapolated that 20 percent of the total portfolio—2,000 loans—contained problems. But to determine exactly which 2,000 loans were at issue and just how serious the problems were, examiners had to plow through the entire portfolio one loan at a time.

With the new technology-based approach, all 10,000 loans would be run through ComplianceAnalyzer. Following the aforementioned scenario, the system would trigger indicators of apparent violations—categorized, no less, in terms of each breach's seriousness—in the 2,000 possible bad files.

With this new process, before the exam team is even deployed, the examiner in charge of the audit will know exactly which files have potential problems and, therefore, will know where and how to employ resources. Examiners still would have to prove the violations, but there would be no guesswork. In other words, examiners will be able to conduct efficient, targeted reviews based on information that has already been brought to their attention.

If there are only a few red-flag hits, any further examination could be done in a more limited scope. Or perhaps the audit could be skipped altogether, at least for that year or testing period. "Not every company is a bad company or needs as much scrutiny as some other companies," says Cross.

Naturally, this new and more focused approach is expected to save time and money for everyone concerned. But even if the software review snags 2,000 hits, the lender is spared the cost of a deeper look-see by examiners digging through the remaining 8,000 loans. Now examiners can concentrate solely on the potentially bad loans.

"It's pretty cool," Pennsylvania's Bleicken says of the system. "Not only can it reduce the time an examination takes, from days and weeks to minutes, we can use it to dramatically increase the scope of what we can find. It's more efficient for lenders, too. They can submit remotely, and we don't have to be physically on-site. The more comprehensive we all can be, the better consumers are being protected."

"It's not just faster and cheaper," Cross agrees, "but it's also better. Comprehensiveness is the future of state mortgage examinations."

Thanks to automated auditing, for state regulators, worrying about examination capacity will be a thing of the past.

Wave of the future

On both sides of the table, there is a single goal—to achieve the greatest efficiencies at the lowest cost and the least burden to both regulators and lenders.

For regulators, ComplianceAnalyzer's reports further this goal by quickly and accurately pointing examiners to any problem areas—places where they need to spend the bulk of their time and resources. The system provides detailed, loan-level analysis that covers federal, state and local regulations. Audits also can be expanded to cover government-sponsored enterprise (GSE) compliance guidance; rules for government-insured loans; and even customized, regulator-specific regulations and policies.

At the same time, lenders need to fully protect their own operational risk by implementing that self-examination that regulators like to see. Only the most diligent internal policies and automated reviews can do that. An institution's automated compliance technology needs to be intelligent to spot not just errors, but also provide a "heads up" that helps them focus on potential issues before examiners ever see them in a mortgage.

By highlighting the degree of risk and explaining in numerical and written terms exactly what is wrong, an effective automated compliance system can tell an institution in real-time exactly what is necessary to bring a loan back into compliance. If users need more information, the full regulation will pop up on the screen so it's clear exactly what the law requires.

"The timing for this couldn't be better," says John Levonick, chief compliance officer and general counsel at Franklin Credit Management Corporation, Jersey City, New Jersey. "Historically, the secondary market was relied upon as the arbiter of compliance. But now that it has proven itself unable to fulfill that role, the states are pretty much driving the market for determining compliance standards."

Now it's time for lenders to get on board, says Burton Embry, a long-time ComplianceAnalyzer user who is vice president of compliance and quality assurance at Franklin American Mortgage Co., Franklin, Tennessee. "Regulators are out there looking, and the fact that both lenders and regulators can operate on the same platform and audit against the same baseline standards should make for very consistent results," Embry says. "It should eliminate the guesswork and make life easier for everybody."

> *Regulators clearly recognize that an automated compliance system such as ComplianceAnalyzer helps them do more with less.*

We agree. Regulators clearly recognize that an automated compliance system such as ComplianceAnalyzer helps them do more with less. It's no coincidence that their new initiatives come at a time when all signs point to a more complex regulatory landscape as they grapple with the credit crisis and the issues that caused it. Similarly, financial institutions also should take a look at their own operations to determine how they can most efficiently prepare themselves for this new frontier of regulatory examination. MB

John Vong, CMB, is president and co-founder of ComplianceEase, a division of LogicEase Solutions Inc., Burlingame, California. He can be reached at j.vong@complianceease.com.