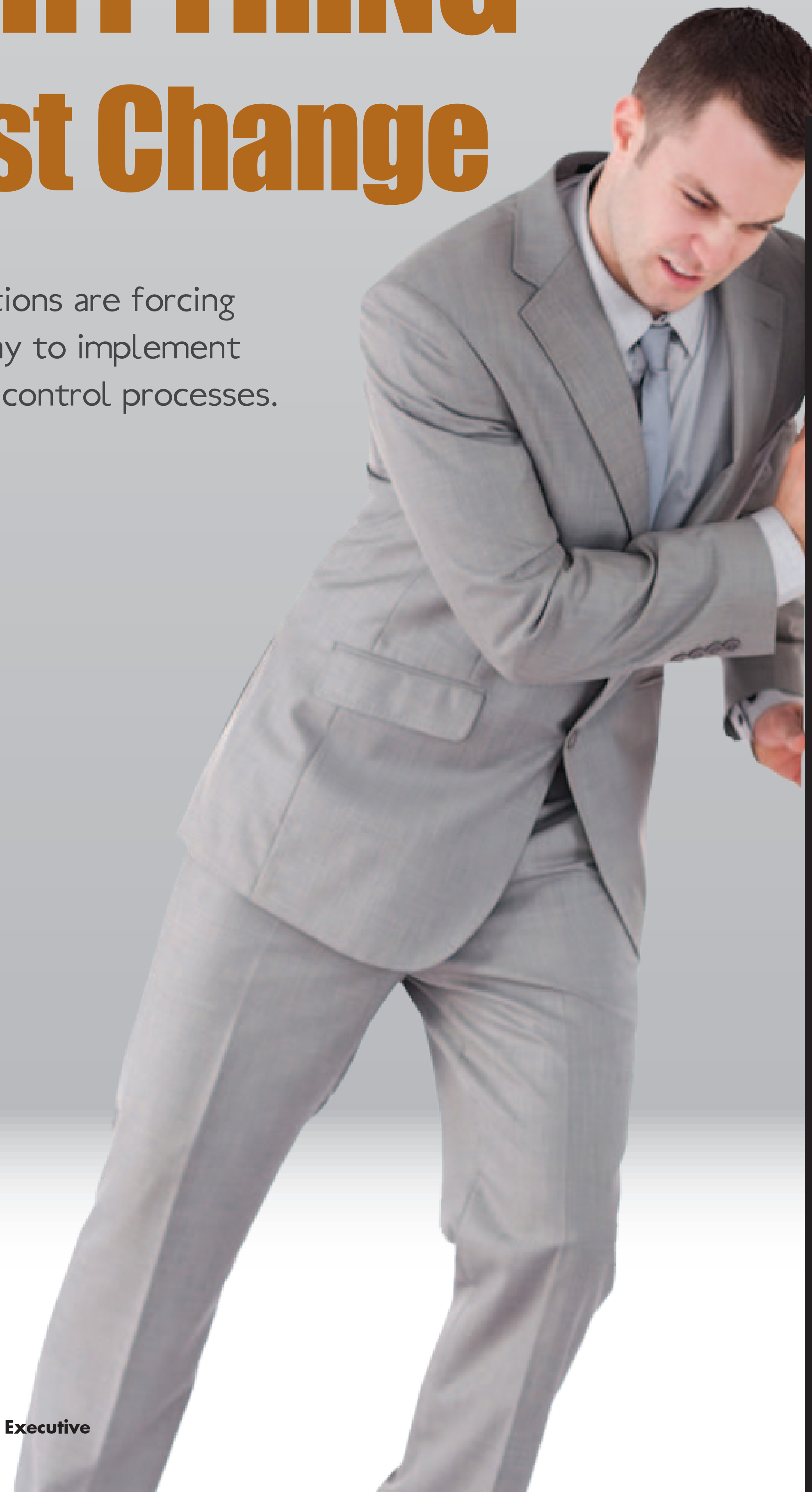
EVERYTHING Must Change – Even Your LOS

New regulations are forcing lenders today to implement new quality control processes.



By Tim Anderson

The one thing we all know about change is that it's inevitable. And in the mortgage industry, change is not only inevitable it's relentless. Step back and consider where the industry was five years ago. The average 30-year fixed rate has been halved. Housing prices plummeted and now they are bouncing back, even bidding wars are taking place in some markets with low inventories. The correspondent lending market has almost disappeared. Origination volume crested in 2007, then it bottomed out, and now it is again on the rise.

But all this change does not necessarily mean that we ourselves will change. Nor, does it mean that change will lead to progress, in the mortgage industry or anywhere else.

Take, for example, the loan origination system (LOS). When it comes to the level of technology and what lenders truly require to excel in a fast-moving environment, the traditional LOS is slowly losing relevancy. The LOS business model is changing as well, due in large part to unprecedented regulations and oversight of the industry by the Dodd-Frank Act and the Consumer Financial Protection Bureau (CFPB). It's no longer about how fast you can process loans. Regulators now want to be able to see historical data on every application as it moves through the mortgage process. Meanwhile, lenders not only need to be compliant with the fast-changing rules, but for obvious reasons, they desire to reduce buyback risk as well.

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Over the years, the level of innovation in the mortgage industry evolved to the point where an LOS should be able to handle these demands. Some of the brightest minds in our industry have already created the tools. In other words, the technology has progressed. It also has the potential to lead to better risk management, which could, for example, help resurrect correspondent lending. And yet the bulk of LOS providers, and by extension, lenders themselves have neglected to change along with these innovations. In fact, there are only a couple of LOS and technology providers in the market today who have realized this strategic shift and have adjusted their business models accordingly.

OUT WITH THE OLD…

This stagnation among the LOS market has truly dire consequences for lenders. Never before have lenders faced such a groundswell of scrutiny than they have over the past five years, from Wall Street investors, federal regulators and the American public. To help lenders be successful in the new regulatory environment, LOS must become aggregators of loan data supported by a common data set and language, capturing data from application to closing and beyond. By doing this, not only will they help lenders originate loans in compliance with new regulations, they will give lenders the data to prove it.

But what is holding things back? In today's mortgage industry, loans have become highly commoditized. The variety of loan products has shrunk with the mortgage meltdown. There isn't much difference between a 30-year-fixed FHA loan at Chase versus a 30-year-fixed loan at Wells Fargo. Likewise, there isn't much difference in LOS products, either in quality or level of technology. There are only slight variations between them. And with more and more LOS solutions hosted in the cloud through a web transaction model, the playing field has been leveled further, making price the only real competitive advantage.

While the LOS is not changing, the industry certainly is. When the CFPB begins auditing lenders on suspicion of discriminatory practices or overcharging borrowers, it will not matter how inexpensively priced your LOS is. Regulators will only be interested in the loan and application data that either demonstrates that a lender made proper disclosures to borrowers at the right time, even if the loan did not close, or if the GFE was accurate, or whether the loan fell into the category of a high-priced loan.

Today's LOS must reflect and respond to regulatory and investor demands on how loans are to be processed. The real competitive edge is not on price, but rather on managing risk and being able to properly validate data to certify the quality of the loan and proving it to regulators and investors. In every aspect of the mortgage business, we witness signs that risk management and compliance have become the industry's number-one priority. We see it in the rise in borrower verifications that lenders are conducting, to the increase in loan reviews that take place before closing, to the number of correspondent lenders that are dropping out of the business because they do not want to assume third-party risk.

The technological building blocks of this new, risk-adverse dynamic in the LOS industry are already in place. Aided by new industry standards, companies that become aggregators and analyzers of loan data will become the new systems of record for regulators, investors and the industry. With its Uniform Mortgage Data Program (UMDP) loan quality initiative, the Federal Housing Finance Agency (FHFA) embraced MISMO 2.6 for its Universal Appraisal Dataset (UAD) and MISMO 3.0 for its Uniform Loan Delivery Dataset (ULDD) delivery of mortgages into the secondary market. Thus the stage is set for the new LOS aggregator of loan data to transform the market.

…AND IN WITH THE NEW

Not only compliance, but technology is driving change. Two models in the LOS industry have started to come to the fore. The first is a middleware cloud-based system where a mortgage technology provider takes over the traditional responsibilities of the LOS in order to aggregate loan data and provide an automated loan quality audit. Such a system makes it possible for large banks to remain in the correspondent lending business, as the middleware

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system perfects the process to certify loan quality. Hence, providing the bank with a level of quality assurance and certified data process to fund without recourse.

The second model to emerge is to embed this process with the LOS itself. This allows lenders to deliver an electronic audit to show investors and regulators that it is able to meet their loan quality standards. It’s an uncomplicated process in which the lender is able to retain control over all data and documents at all times while validating the data through the workflow. It is not about how inexpensive, quick or efficient the LOS solution is. Fannie Mae, Freddie Mac and other investors, and brand new investors, are demanding proof of loan quality, not proof of how quickly or cost-effectively lenders are able to originate. It’s about which system can best prove that the loan followed a validated data process.

Being able to collect and validate loan data and integrate this process into the loan production chain has other benefits too. The current lack of LOS solutions that can consistently implement a true automated loan quality workflow process around investor guidelines is one reason why correspondent lenders left the market. When the market sees the new LOS standard in use, and when it can be assured of no third-party risk, I believe correspondent lenders will return to the market.

In the past, I helped develop a system for credit unions that mirrors some of what is going on today. To assist Fannie Mae’s acceptance of their loans, the system enabled credit unions to aggregate their loans onto one platform. The loans were run through Fannie’s Desktop Underwriter. And based on the findings it implemented a lights-out workflow process that continually revalidated the information to ensure it still met the credit quality criteria to receive a DU approval. It continued to perfect this process to the point where Fannie Mae could trust the data process and did not have to re-underwrite a majority of the loans. This not only saved time, but obviously increased the quality of loans as well.

LOOKING AHEAD

What’s next? I predict the leading LOS shops that have implemented intelligent investor data validation workflow processes might even start giving away their LOS to lenders. The value really is not in the software itself but in what it derives as an end product. Using a different business model, these providers will instead make their money on providing data-driven analytics. Lenders will pay for loan quality. As for the smaller LOS shops, they are expanding their presence in the market by buying servicing software platforms to complement their origination systems. It will be interesting to see if they can compete with the giant servicing machines. But in the end, they will have to become data aggregators to deliver a validated loan product and process across the entire loan transaction as well, in order to create their own niche in the LOS market.

Those companies that can aggregate loan data all the way through the mortgage process, including origination, servicing, foreclosures and loss mitigation, will take the new LOS model a step further. This full life and loan cycle data approach will create the ability to pinpoint errors at any point during the life of the loan, and enable anyone to find out why loans defaulted or were bought back. The real goal is to go beyond the traditional LOS and use the data to fix any problems before a loan gets to the servicing shop.

Meanwhile, obtaining, aggregating, storing and sorting through all the electronic loan evidence will take place on the cloud. The cloud will become a centralized repository of loan data, like an enterprise system of record. This is simply practical, since no LOS or lender can recreate a loan for a regulatory audit in a paper world.

The bottom line is that the mortgage industry will continue to change, and if lenders want to stay relevant, the traditional LOS must evolve and change along with it. Right now we are dealing with sweeping changes associated with Dodd-Frank and the CFPB. In another five years, it will be something else. While the bulk of LOS companies have struggled to adapt, the ones that do will have the world at their feet. ❖

About The Author

During his career, Tim Anderson has been involved in many aspects of the mortgage industry and has acquired more than 30 years of mortgage and technology experience. Most recently, he has been heavily involved on the technology side of the industry, where he played an instrumental role in developing one of the first e-mortgage platforms, including e-signature and e-vaulting technologies. At ISGN, Tim spearheads the effort to define the company’s technology strategy, with the goal of creating next-generation platform.