

# Retail Banking Insights

Number 4

August 2014

## Creating a Robust Risk-and-Control Framework in Mortgage Lending and Servicing

Lenders and servicers in today's U.S. mortgage industry face intense regulatory scrutiny, and must conform to stringent operating standards and process requirements. Business, risk and compliance executives have to demonstrate robust risk oversight and the ability to identify and remediate exposures in a timely fashion. Furthermore, mortgage leaders must achieve these goals without creating extensive process overlays, onerous policies and procedures, and multiple lines of checkers that can become a drag on a successful business.

To succeed, mortgage lenders and servicers must move away from the paradigm whereby they attack risk exposures by adding more layers of complexity. Instead, they must institute a framework that enables them to identify their highest-priority risks and get at the root causes of defects. Through work with industry participants, McKinsey has developed such a framework, and synthesized a set of steps that can help mortgage executives develop strong and effective controls and oversight while ensuring that the mortgage business is still a profitable one.

### **An industry under the microscope**

Driven by dramatic increases in home mortgage defaults during and after the financial crisis, regulators focused their attention on consumer and investor protection. Banks' mortgage default servicing operations attracted heavy scrutiny that continues today. Regulators then expanded their focus to include origination and performing servicing. The result is that consumer protection laws<sup>1</sup> — both new and pre-existing — place extensive requirements on lenders to deliver timely and accurate disclosures, notices and credit decisions; to charge fees only for permissible charges; and to meet many other consumer protection standards.

<sup>1</sup> These consumer protection laws include, among others: The Consumer Financial Protection Bureau's Ability to Repay rule, the Real Estate Settlement Procedures Act (RESPA), the Truth in Lending Act (TILA), the Fair Credit Reporting Act (FCRA), the Equal Credit Opportunity Act (ECOA) and the Servicemembers Civil Relief Act (SCRA).

On the investor side, protective laws and credit quality requirements are also tightening. For instance, ability to repay and qualified mortgage regulation could lead to increased litigation risk and weaker economics for a significant share of loans. Another source of increased litigation risk is the U.S. Department of Justice's (DOJ) scrutiny of Federal Housing Administration (FHA) loan requirements. The DOJ is imposing even tighter materiality standards on banks than those to which the FHA has long adhered. Partly as a result, litigation settlements issued by the DOJ in 2012 ranged from \$132 million to \$1 billion.

### Complexity and the cost of controls

Mortgage executives face a number of challenges in developing a control infrastructure that will enable them to operate effectively in the current regulatory environment:

- **Transparency.** Despite a multitude of controls and increased audits, many lenders and servicers simply cannot determine what the major issues are and where they occur. The inventory of critical risks is often not established; rather, there are hundreds, sometimes thousands of individual controls that are being managed. Rarely is the residual risk measured and reported in a systematic manner that gives executives a clear picture of where the "hot spots" are. As a result, major risks might go unaddressed until they are discovered in regulatory audits.
- **Risk control.** At some banks, there is little confidence that risks are effectively controlled. Lines of defense tend to focus on developing extensive libraries of controls and on performing time-consuming, bottom-up subjective assessments, as opposed to providing objective measurement of residual risks for critical regulatory requirements.
- **Root causes.** Rather than addressing the root causes of defects, some institutions add lines of manual checkers. For example, a servicer may have extensive manual checks of compliance with dual-track foreclosure rules, instead of taking the more effective approach of automating foreclosure holds and releases altogether. Similarly, some lenders may have multiple checkers conducting post-closing verifications that borrower fees are supported by documentation, instead of addressing the root cause of errors in the Good Faith Estimate (GFE) disclosure and re-disclosure processes.
- **Accountability.** The accountability of first and second lines of defense is often defined only at the overall level, potentially leaving gaps or overlaps at the level of individual risk. For instance, both first and second lines might be testing Home Mortgage Disclosure Act compliance, while compliance with the Equal Credit Opportunity Act's requirement to make and communicate underwriting decisions within 30 days could be omitted.
- **Technology investments.** Investments in compliance automation are often insufficiently focused on the process steps that create legal and regulatory exposure. Banks can sometimes undergo major tech platform upgrades without clearly defining the functionalities that address most serious risk exposures; thus, after years of investment, they may end up with a system that is not fit for its purpose.

### Building a robust controls framework

Designing and constructing a mortgage risk management framework equal to the challenges of the current regulatory environment is an effort with a high payoff. A robust framework includes the following six elements:

### 1. Prioritized inventory of critical risks

The foundation for an effective risk management framework is a prioritized inventory of critical risks and regulatory requirements across origination, servicing and default. In mortgage, around 70 regulatory and investor risks typically can be classified as top priority. These include known consent order issues such as accuracy of foreclosure affidavits and compliance with the dual-track foreclosure rule, as well as consumer

protection requirements (e.g., timely and accurate disclosures; compliance with the 30-day Equal Credit Opportunity Act [ECOA] credit decision timeline).

The imperative to focus on top priority risks is not meant to diminish the importance of other risks, but rather to suggest that organizations begin by identifying and addressing the risks that create the greatest exposure. A prioritized inventory approach is more actionable, practical and effective than an oversight framework with a thousand controls and hundreds of detailed findings. Monitoring relatively limited key risk indicators for residual risks is also far more efficient than testing the numerous controls (Exhibit 1).

Monitoring relatively limited key risk indicators for residual risks is far more efficient than testing the numerous controls.

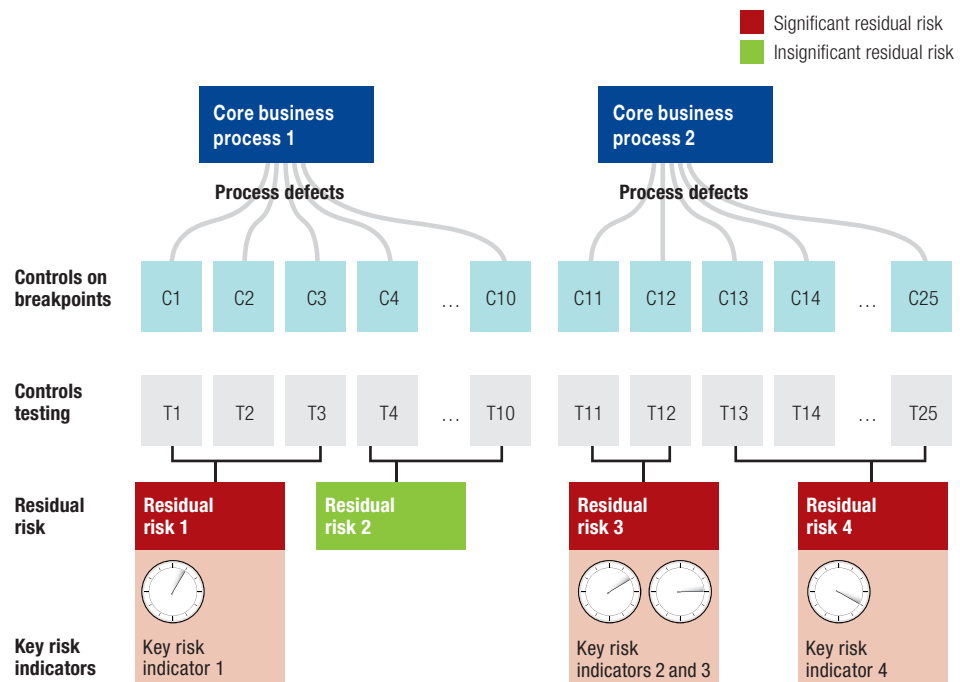
protection requirements (e.g., timely and accurate disclosures; compliance with the 30-day Equal Credit Opportunity Act [ECOA] credit decision timeline).

### 2. Risks tied to specific process breakpoints

The next important element in developing a strong risk controls framework is a detailed taxonomy of processes within each mortgage area that ties critical risks to specific breakpoints in these processes. As an example, there are typically 10 critical risks

Exhibit 1

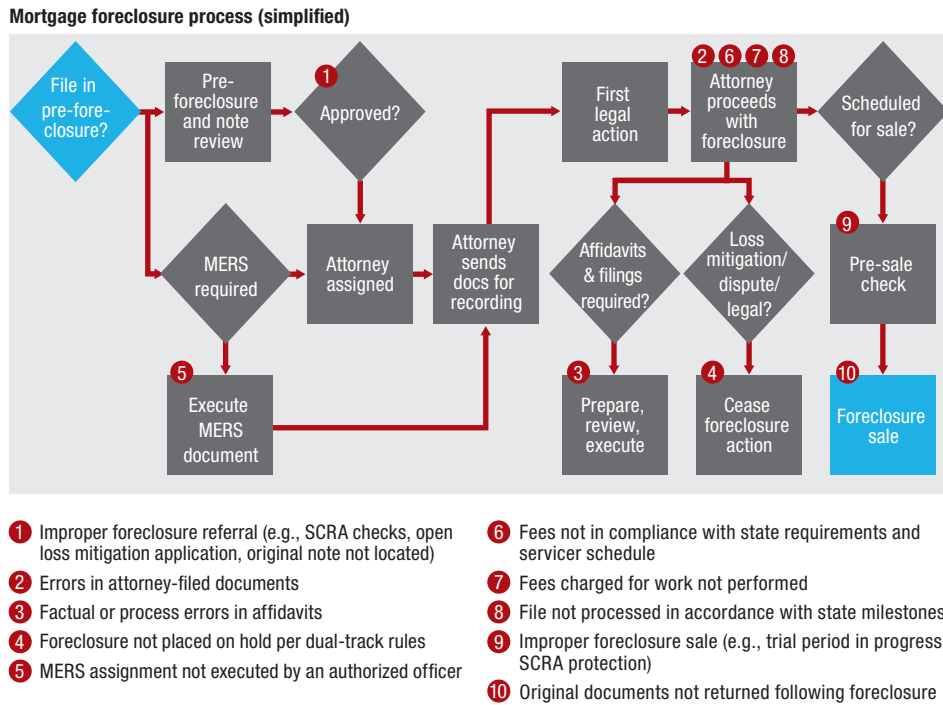
A focus on residual risks in critical process breakpoints leads to more effective risk identification



Source: McKinsey analysis

Exhibit 2

Ten critical regulatory risks are typically associated with the mortgage foreclosure process



associated with the mortgage foreclosure process; four arise as part of the activities undertaken by foreclosure attorneys after the first legal action is filed (Exhibit 2). Tying risks to the specific process breakpoints where they arise in this way is critical to defining actionable controls, creating an effective quality assurance and control program, and remediating risks that perform outside of tolerance.

**3. Objective key risk indicators**

The next important step is to assess the level of residual exposure through objective, quantitative key risk indicators (KRIs) and tolerance levels—that is, to detect those risks that have a defect rate that exceeds the bank’s risk appetite. KRIs give managers a clear view on how each process breakpoint is performing (Exhibit 3, page 5). For example, does the lender have unacceptable level of defects in complying with ECOA standards? What is the objective defect rate in complying with Servicemembers Civil Relief Act (SCRA) restrictions on mortgage interest rates? With the answers to these questions, lenders and servicers avoid extensive, time-consuming qualitative controls assessments; they can instead focus on the risks that exceed tolerance.

**4. Optimized responsibilities of lines of defense at the individual risk level**

To ensure comprehensive coverage of high-risk areas and eliminate rework and overlaps, banks need to unambiguously define the roles within each line of defense. Moreover, this definition must apply at the level of individual critical risks. In the framework we are describing, the first line’s primary responsibility is to keep risks within the tolerance thresholds using the tools at their disposal: process re-engineering, automation, staff training and performance management, or a formal quality control program. The

Exhibit 3

Key risk indicators provide an objective measure of residual risks and a clear view on how each process breakpoint is performing

Mortgage origination example			
Regulatory risks	Key risk indicators	KRI	Residual risk <sup>1</sup>
GFE disclosures timely and complete	Percent of disclosures sent >3 days	1%	Medium residual risk
	Percent of QC error rate on disclosure	5%	Medium residual risk
Borrowers charged settlement cost per GFE	Percent of times settlement costs and loan terms on final GFE don't match HUD-1	5%	Low residual risk
ECOA credit decisions made in 30 days	Percent of credit decisions made in more than 30 days	2%	Medium residual risk
Adverse letter accuracy	Percent of defect rate on adverse letters	5%	Low residual risk
Finance charges within range	Percent of finance charge exceeding 3% of loan amount	1%	High residual risk
Waiting period for closings met	Percent of loans closed before 3-day right-to-cancel period	1%	High residual risk
Borrower identity verifications	Exception reporting	8%	Medium residual risk
Appraisals meet quality requirements	Percent of defect rate on appraisal	5%	Low residual risk
Fraud checks as required	QC audit check (5% sample) for evidence of work	1%	Low residual risk
Critical documents in place	Percent of missing documents (bureau, HUD 1, 1003, AUS report)	5%	High residual risk

<sup>1</sup> Risk remaining after risk management and remediation effects  
Source: McKinsey analysis

second line's responsibility is to ensure that the risk inventory is complete and that it captures critical regulatory requirements; they do this by validating KRIs and setting standards and by conducting regular independent testing to measure error rates for critical risks.

The scorecard pinpoints areas with high error rates that demand immediate attention, and functions as an ongoing management tool for tracking program effectiveness and ensuring timely escalation and remediation of defects that exceed tolerance.

It is important to note that at many lenders the second line includes separate operating risk and compliance organizations; in these cases, oversight of individual risks should be assigned to a single unit to prevent overlaps and redundant effort.

**5. Transparency into risk exposure**

Overall risk exposure and performance should be tracked with a scorecard that shows objective KRIs for each risk across channels and products. The

scorecard pinpoints areas with high error rates that demand immediate attention, and functions as an ongoing management tool for tracking program effectiveness and ensuring timely escalation and remediation of defects that exceed tolerance. This trans-

Exhibit 4

A risk scorecard can pinpoint areas with high error rates, or “hot spots,” that demand attention from management

Partial example of mortgage origination scorecard

	Q1	Q2	Q3	Q4	Trend	Root cause of defects	Remediation plan	Remediation status
RESPA - Initial GFE	0	7	2	0	↗			
RESPA - Revised GFE	0	4	11	0	↗			
RESPA - charged sett. cost per GFE	0	0	0	0	→			
RESPA - HUD 1	0	2	0	15	↘	HUD-1 not validated upon receipt from title company	Introduce HUD-1 validation tool to be used by closers	🔄
RESPA - Initial escrow	0	2	3	0	→			
ECOA - Notice of Incomplete	17	12	48	2	↗			
ECOA - credit decision within 30 days	0	7	2	0	↗			
ECOA- discriminatory factors	0	0	0	0	→			
TIL disclosure	0	2	3	0	→			
TIL redisclosures	0	2	11	0	↗			
TILA - APR and finance charge	0	4	9	5	→	Processors rely on memorized P&Ps to assess charges	Develop charge table with clear tolerances	🔄
TILA (MDIA)	0	0	0	0	→			
HMDA reporting	17	32	48	2	↗			

■ Exception rate exceeds threshold by >5%    
 ■ Exception rate exceeds threshold by <5%    
 ■ Exception rate below threshold

Source: McKinsey analysis

parency allows management to immediately focus on the risks that require attention, and to avoid spending time and effort on those that are performing well (Exhibit 4).

**6. Root causes**

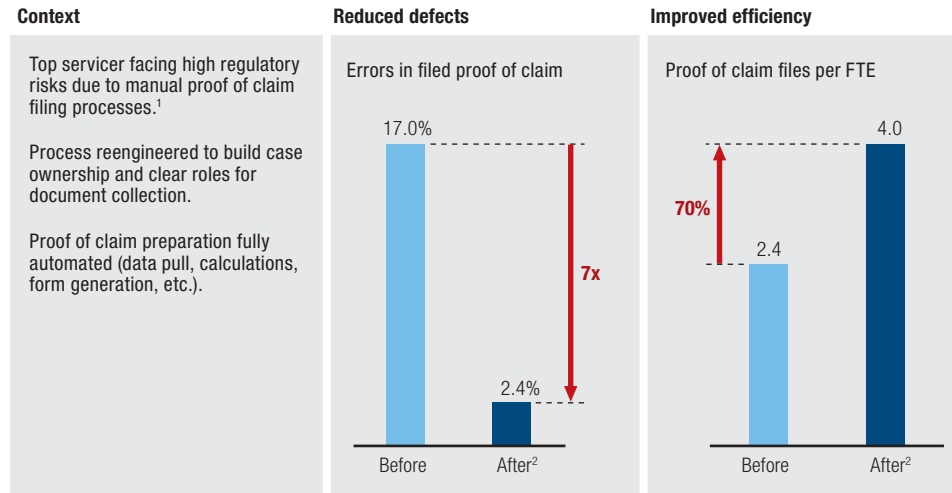
The objective measurement of defect rates almost always uncovers regulatory risk breakpoints that exceed tolerance levels. While the natural response is to add a line of checkers, this adds unnecessary complexity and process costs. Banks are better served by digging deep to understand why errors arise in the first place, and redesigning and potentially automating the process to eliminate the underlying root causes. Solutions can include:

- Codifying complex processes and compliance requirements into a prescriptive workflow
- Eliminating hand-offs and establishing clear responsibility for quality (e.g., processors are solely accountable for the quality of the documentation in the file and cannot move the file to underwriters unless it meets predefined quality requirements)
- Expanding upstream data capture to enable automation and systemic generation of regulatory disclosures (e.g., pre-foreclosure letters)
- Automating system triggers (e.g., foreclosure holds per dual-track rules), calculations (e.g., disclosed fees), generation of letters and regulatory filings (e.g., bankruptcy proof of claim), and other high-risk steps susceptible to manual errors
- Enhancing management tools and exception reporting to capture regulatory defects before they occur (e.g., exception reports showing the files that will be missing the three-day timeline for GFE disclosure letter)

Exhibit 5

Process redesign and automation addressing root causes of defects can both reduce risk and increase frontline productivity

**Bankruptcy proof of claim example**



<sup>1</sup> Defects include late filings, defects in facts and figures, compliance with local rules.

<sup>2</sup> Before full automation

Source: McKinsey analysis

To remediate high defect rates in GFE re-disclosures, one leading mortgage originator made its processors directly accountable for assessing changes of circumstance, calculating fees and sending re-disclosure letters. Under the revised process, processors use an automated tool to make assessments. The result was a reduction in defects from more than 30 percent to below 5 percent. In another example, a leading servicer reengineered the process flow in its bankruptcy processes, eliminating hand-offs, setting up a prescriptive workflow and automating pulls of data from the system of record; as a result, defects declined seven-fold while productivity increased by 70 percent (Exhibit 5).

**Payoff: Reduced risk exposure and operating costs**

The current regulatory environment demands a robust risk oversight framework for mortgage lenders and servicers. With the right approach, banks can both meet their regulatory expectations and reduce operating costs. Benefits of implementing a robust risk controls framework include:

- Full transparency into critical risks, allowing management to prioritize remediation efforts and automation investments
- The ability to demonstrate to regulators that risks are objectively measured, managed and controlled
- Refocusing of organizational resources on 50 to 70 critical risks (as opposed to the hundreds or thousands of process controls, many of which do not actually contribute to risk reduction)
- A 30 to 50 percent efficiency improvement in the control functions, through the replacement of manual and subjective control testing with objective defect rate measurement

- Ability to remediate root causes of defects, which can result in 50 to 70 percent productivity improvement among frontline staff

### Self-assessment

Building and maintaining a streamlined, industrial-strength risk-and-control framework in mortgage is a major initiative that requires regulatory and compliance expertise, executive judgment, and in-depth knowledge of mortgage processes. The development of such a framework can start with a leadership discussion on the following questions:

- Do we have objective reporting on how regulatory risks perform in our operations? (E.g., What is the defect rate on RESPA re-disclosures? What percentage of proof-of-claim filings contains defects? What percentage of loan modifications may have been improperly declined?)
- Are we aware of the regulatory risks that are performing outside our tolerance levels?
- Do we have a fact base that we can share with regulators showing which mortgage risks are actively managed and how they are performing?
- Are we satisfied with the effectiveness of the group dedicated to control activities?
- Are we relying on lines of checkers verifying other checkers? Excessive manual controls? Quality control focused on non-material issues?
- Are we confident that our process engineering and automation investments are focused on critical risk exposure areas?



For U.S. mortgage originators and servicers, the heightened regulatory focus presents a clear challenge but not an insurmountable one. The critical regulatory risks and corresponding process breakpoints for origination and servicing are well known; the types of process interventions that can address regulatory defects at their root causes are well established as well. By following a framework of the kind described in this paper, banks can not only meet regulatory scrutiny, they can also reduce costs and streamline their oversight processes.

**Piotr Kaminski** and **Dmitry Krivin** are principals in McKinsey's New York office. **Kate Robu** is an associate principal in the Chicago office.