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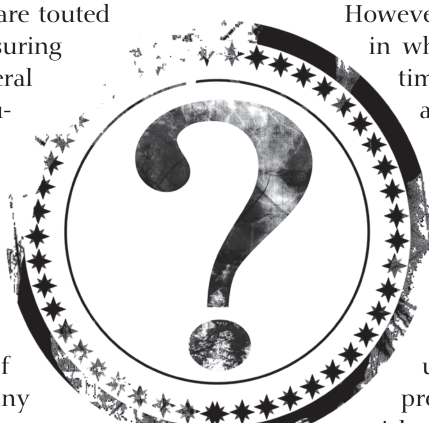
No Compliance Guarantee

Vendor claims of regulatory-compliant technology should be scrutinized.

By Jacqueline Doty

AS LENDERS WORK TO IMPLEMENT NUMEROUS regulatory requirements and meet multiple compliance deadlines, many vendors are responding with innovative risk management products and services. In the collateral risk space, we see tremendous innovations in modeling, like artificial intelligence techniques used to identify fraud; data, with new partnership structures with multiple listing service boards; technology, including large scale systems that permit continuous valuing of all U.S. properties; and hybrid products, such as property inspection reports tuned to automated valuation assumptions. These innovations have benefited the mortgage industry by reducing risk while supporting lender compliance with new regulations.

Given vendor interest in satisfying client demand for these services, it is no surprise that some of the valuation and inspection products are touted as meeting or ensuring compliance with federal guidelines. Unfortunately, these claims are overstated.



Simply put, there is no product that can be guaranteed to comply with the federal guidelines simply by virtue of its use. Although many vendor products are frequently used in a compliant manner by regulated institutions, the use of a specific vendor's automated valuation model or inspection report is not, in and of itself, sufficient to comply with the federal guidelines. Want proof? Ask any vendor claiming its product is compliant to provide certification by a regulator. Or, for courageous lenders out there, ask your examiner for a list of vendors approved for use.

Property valuations provide an excellent case study on this issue. Revised Interagency Appraisal and Evaluation Guidelines were issued in December 2010 by the federal financial regulators. These guidelines place considerable focus on risk-based appraisal review, AVM requirements and valuation updates during the life of the loan. The guidelines went into effect almost immediately, causing lenders to quickly attempt to come into compliance. Many lenders began searching for products and solutions that would meet the federal guidelines.

Responding to these new market demands, a number of vendors created a host of new property valuation and property inspection products. Several vendors claimed their new products were fully compliant with these guidelines.

However, given that the manner in which a product is used ultimately determines whether a lender is compliant, these claims can't be substantiated. In addition, the complexity of the compliance burdens created by the federal guidelines requires lenders to do much more than simply use a particular type of product — they must also set risk limits, develop exclusion criteria, prevent value shopping and ensure that people performing evaluations are qualified.

There is no "seal of approval" process, nor are individual vendor products blessed by regulators. Why is this so? Consider the following scenarios: What if a model begins to deteriorate over time? Is the valuation approach used on a 50% combined loan-to-value second mortgage also applicable for a 95% LTV loan modification? Is a valuation conclusion still valid if a natural disaster impacts the property or the market it's in between the valuation date and loan closing?

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Effective use of any valuation product depends as much on the associated loan program, underwriting process and valuation review as it does on the features of the valuation product. Examiners can find use of a specific product acceptable for one institution, but not for another. Even within a single institution, a product may be acceptable for one loan program, but not another.

To illustrate, consider two hypothetical lenders, both interested in using AVMs as the foundation for an evaluation — note that an "evaluation," as opposed to an "appraisal," is a valuation for low-risk transactions, consistent with the agencies' regulations.

Lender A and Lender B want to use the same automated valuation model to estimate the market value of homes for new home equity lines of credit.

Lender A performs semi-annual testing of the AVM in-house, using its purchase mortgage pipeline to obtain a statistically significant sample within its footprint. Lender A establishes a policy to only use evaluations for loan applications from well-qualified borrowers with significant equity. Lender A's evaluation program precludes use of AVMs in any county where the AVM performance was subpar or where a natural disaster has been declared by FEMA in the prior three months.

In addition, Lender A further establishes a monitoring program to compare loan performance for loans that were made based on evaluations as compared with loans that were made based on appraisals.

Lender B relies solely on testing results from the AVM vendor, which were last updated in first quarter 2010. Lender B's policy is to use the AVM anytime the AVM value supports approval of a home equity application. Lender B cannot track the performance of evaluation-based loans separately from appraisal-based loans.

Obviously, this is an exaggerated scenario. However, it demonstrates how testing and monitoring practices could influence the ability of two lenders to manage loan risk.

What if the model does not perform well in Lender B's business footprint? And what if Lender B has aggressive lending guidelines? It is possible that the examiner will allow Lender A to continue using the AVM as the foundation for an evaluation, but Lender B may be asked to adjust its program.

How Lenders Should Respond

Lenders interested in how a vendor's product supports compliance should thoroughly investigate the vendor's claims. Performing due diligence on the vendor and its products is critical, both at the outset and ongoing.

Credible vendors will provide references so lenders can speak to peers who have been through an examination using the product. Regulatory compliance will be very challenging, as the largest set of regulations affecting compliance will come with the Dodd-Frank Act, which creates 13 new federal regulatory agencies, including the new Consumer Financial Protection Bureau.

Some lenders opt to outsource compliance-related tasks such as AVM testing. While some lender clients report good success with this approach, others report challenges. The recent guidelines admonish lenders to "use caution if it engages a third party to administer any part of its appraisal and evaluation function." In other words, responsibility for compliance remains with the institution, not the third party.

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A review of the third-party vendor's product should include sufficient analysis to determine what gaps the lender must fill on its own to fully meet the institution's performance standards and regulatory requirements.

To avoid the risks of noncompliance, specific issues and questions about compliance matters should be raised either with the appropriate contact at the institution's primary regulator or competent counsel with subject matter expertise. Most third-party providers have an earnest desire to be helpful to their clients, but compliance, ultimately, is in the eye of the lender's regulators.

How Vendors Should Respond

Vendors should continue to provide the industry with innovative solutions that support sound risk management and address ever-evolving compliance concerns. However, vendors must also remain abreast of regulatory changes and work proactively with both lenders and regulators to design effective products.

Vendors should also help clients by providing useful insight about how their product or service can assist them in complying with regulatory requirements, without making overstatements. A responsible vendor will not only explain how its products can help institutions comply, it will also be explicitly clear on the aspects of regulatory compliance that are not addressed by the product.

Lenders appreciate hearing how regulators respond to the use of a product. Vendors can share feedback from other lenders who use the product and have undergone an examination. When sharing this information, however, it is important to include the caveat that the ways lenders use a product differ.

For any given product, an examiner may find the product is acceptable when used by one institution, but not by another, depending on various factors such as the lender's policies and controls, and its overall risk profile.

Financial institutions increasingly rely on third-party vendors to perform vital functions related to compliance. While vendor products and solutions can be beneficial to support compliance in many ways, firms should be skeptical of AVMs and inspection reports that are marketed as "fully compliant" without proof or detailed explanations.

Day-to-day management of a product or service can be transferred to a third-party vendor; however, ultimate responsibility for all compliance requirements cannot be delegated and always remains with the financial institution. MT

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