

A Pro/Con Analysis Of Loan File Diversification

The lack of concrete detail in the OCC's servicer consent orders has left abundant room for interpreting risk mitigation guidance.

by Scott Goldstein

When 14 major mortgage servicers signed consent orders with the Office of the Comptroller of the Currency (OCC) in April, it was evident that the new guidelines would likely generate some significant introspection, self-analysis, discussion and debate within the industry. And when the OCC subsequently broadened the scope of the consent orders to encompass all servicers under OCC purview, that likelihood became a certainty. From processes and policies, to paperwork and personnel, the OCC consent orders set forth a number of best practice guidelines for servicers and default law firms alike.

While the consent orders were intended to reinforce and reemphasize compliance standards, promote consistency and accountability, and bolster responsible business practices, the sometimes broadly stated guidelines have generated a mixed reaction within the industry. Though the guidelines set forth in the report are clearly well intended, the language is often noticeably short on specifics. That relative lack of concrete detail has left abundant room for interpretation, and default law

firms around the country have been offering up a wide range of professional explanations. That uncertainty is most evident in what many firms consider to be one of the most important items in the report: risk mitigation.

The risk mitigation language in the consent orders consists of general, non-specific statements regarding risk management "processes," adequate "risk management, quality control, audit and compliance programs," and

The seemingly obvious parallel to a diversified investment portfolio makes this an appealing solution. But the comparison is not an exact one, and a diversification strategy may have as many—if not more—weaknesses than a traditional consolidated approach. Few investors would choose to entrust a small portion of their assets to a large number of different financial advisors; there are obvious inefficiencies and potential complications that could arise

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"appropriate reviews of mortgage servicing, loss mitigation, and foreclosure activities and operations." With vague references to "deficiencies" and "remedies," there is little indication as to what those specific solutions might be. In the default servicing industry, many firms and individuals have concluded that the best strategy to achieve the risk mitigation goals outlined in the consent orders is diversification—expressing the notion that it might be safer for servicers to spread their files out across several default law firms in order to minimize the risk.

from such a scattershot approach. But is the same dynamic true with regard to default law firms? What follows is a review of how a consolidated approach stacks up against diversification with regard to quality performance, outstanding results and optimum risk mitigation. Is diversification really the best way to respond to the OCC consent orders, or is it better to rely on the experience and expertise of one trusted and proven firm? And if it does make sense to keep all of your eggs in one servicing basket, what is the best way to ensure that you end

up with a tasty omelet and not a scrambled mess?

Because the OCC orders provide only a blanket statement regarding risk mitigation and steer clear of issuing any specific detailed mandates (without any specified concentration percentage along the lines of "No firm will receive more than X% of all referrals"), there have been a series of seemingly arbitrary decisions regarding what constitutes "enough" diversification to meet the new guidelines. More than a few lenders have pursued (or at least seriously considered pursuing) a strategy of dividing their workload amongst a number of default law firms; a number that sometimes appears to have been chosen virtually at random, in the hopes that it will satisfy the requirements. The question naturally arises whether such strategies are being made from a position where high-quality service is the top priority, or whether an abundance of caution and concerns about compliance mandates and potential liability have led to a reactive posture and an unnecessarily suboptimal servicing process. To begin to answer that question, we need to look a little closer at both the advantages and disadvantages of a more diversified strategy:

Sharing the load

Far and away the most attractive benefit of a diversified servicing approach is that it typically reduces the chances of a catastrophic

loss. In the wake of the subprime mortgage crisis and a series of subsequent industry scandals, any approach that promises to reduce risk and ensure continuity in the event of a disaster seems like an appealing alternative to what has been a turbulent status quo for so many lenders. Additionally, diversification can expand the range of voices on the issues at hand, potentially gleaned new insights and perspectives.

There is another very practical reason to pursue a diversified approach: working with multiple default law firms to handle your servicing needs is a concrete step that any lender can point to in order to prove that they have taken action in response to the OCC consent orders. Some lenders appear to be asking the question: "If sharing the load can reduce our exposure and minimize our liability, then why not go for it?"

Going against the spread

While diversification and the notion of "spreading the risk" is often viewed as a positive attribute, many professionals understand that the operational mechanics of the default servicing industry are fundamentally different than the process of picking stocks for your investment portfolio; the same logic does not apply. There are a number of compelling reasons to believe that the best approach—both in terms of providing optimum risk mitigation and in terms of providing the best and most efficient service—is similar to that expressed in a quotation that has been alternatively attributed both to Mark Twain and to Andrew Carnegie: "The wise man puts all his eggs in one basket and watches the basket."

First and foremost, a consolidated approach is almost always more conducive to consistency and quality. In the world of mortgage default, all firms are not created equal. There may be a significant diminution in quality between one firm and the next, and that "quality gap" can cost servicers, both literally and figuratively. If a patient needs open heart surgery, that patient's best strategy is to trust his or her life to the expert cardiac surgeon who routinely performs this surgery skillfully and successfully. In the servicing profession, as in the world of medicine, it makes sense to prioritize experience and expertise; you want the people who do this all the time, and who have demonstrated that they do it better than the other guys.

Additionally, it is not as easy to maintain quality control and monitor how well work is being handled when it is spread out. It is much easier to keep a watchful eye on one egg basket than on several individual baskets. This is an especially important consideration given the fact that a different portion of the OCC consent orders emphasizes the importance of consistent oversight. Spreading out the work also adds additional costs to the equation, and creates logistical inefficiencies and communications complications that can, ironically, actually increase compliance and risk mitigation concerns. Competition between providers can also create a framework for bad decision-making, contributing to a dynamic where firms are competing against each other and may make decisions skewed toward "winning" rather than focusing on best satisfying client needs.

Reaction or overreaction?

Some would say that the industry is prone to overreaction at the moment, largely as a result of compliance issues that several high-profile corner-cutting firms and violators have brought to the fore. The case of Florida attorney David Stern as an instigating factor for the diversification trend is worth mentioning. Stern's law firm and his servicing company, DJSP Enterprises Inc., were Florida market share leaders, representing some of the biggest banks and servicers in the nation. The firms' high-profile scandal and rapid and spectacular collapse in the wake of revelations regarding fraudulent practices and documentation is representative of the kind of worst-case scenario that has inspired much of the diversification talk within the industry.

But while that response is understandable, it is rarely a good idea to model business policies and best practices in response to a worst-case scenario. Reactive solutions that focus on quantity instead of quality are chasing a symptom and not addressing a root cause. The Stern case—and others like it—may be scary, but fundamentally, the issue is not quantity or concentration; it is effective risk mitigation. The Stern case is an example of an integrity gap, and you do not solve that issue by introducing more attorneys into the equation.

So how do you solve that issue and watch that basket of eggs? What should you look for in a default law firm that will enable you to deliver prudent risk mitigation and still maintain efficiency? Talented and experienced attorneys are an obvious priority,

but the best servicers also offer sophisticated and effective case management systems to facilitate efficient workflow processing; proven data/IT security policies to ensure information security and provide disaster recovery and business continuity; and display critical business thinking along with transparency and openness at all times. These are the attributes of outstanding service that lead to risk mitigation.

At the end of the day, it is all about results: providing effective mortgage default processing services. It is about meeting clients' needs effectively and efficiently with integrity and care. And while diversification might be appealing, once you identify a law firm that can deliver those results, it seems counterintuitive and counterproductive to direct a large portion of your work in another direction. **SM**



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