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Rising Tide of Operational Risk Demands Due Diligence in Vendor Selection

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onsidering the potential liability associated with outsourcing by the mortgage banking and mortgage servicing industries, as witnessed by widely publicized high-dollar settlements in government enforcement actions, recent comments of federal financial regulators, and guidance by the Consumer Financial Protection Bureau, servicers cannot be cavalier about the choice of their vendors, or select them with a check-the-box approach to due diligence. Instead, banks and mortgage servicers must ensure that their vendors perform critical mortgage servicing functions in a manner that is consistent with their legal and regulatory obligations and service level standards. Unfortunately, much that has been written on vendor selection focuses on intangible principles associated with risk reduction, with much less practical guidance available on "best practices" for identifying and selecting vendors. This article attempts to fill that gap, and focuses on practical criteria relevant to conducting appropriate due diligence on potential vendors.

Why Outsource Servicing Functions?

A handful of reasons are usually cited for outsourcing mortgage servicing functions: first, outsourcing creates opportunities for enhanced profits through reduction of expenses or creation of revenue; second, it allows servicers to concentrate on their core competencies; third, not withstanding occasional regulatory focus on the risks of outsourcing, the use of third-party vendors is believed by most financial institutions to reduce their risk exposure; and last, outsourcing permits banks and servicers to access needed services from providers with greater expertise and efficiency. Other reasons for outsourcing include third parties' ability to perform local tasks far from the servicer's location. While the recent federal-state \$26 billion settlement with the largest mortgage servicers may have called the risk-reduction rationale into question, these principles, combined with the near-ubiquity of outsourcing, leaves little doubt that this aspect of the business is here to stay. How then, should a servicer select its vendors?

Often, the decision to engage (or retain, or change) a vendor results from a process by which the servicer defines its needs, budget and objectives to a group of potential vendors, in the form of a request for proposal. The servicer's staff reviews the RFP responses, may interview finalists or request a "best and final" proposal, and eventually makes its decision. However, because of the expanding number and variety of vendors in the market, the RFP approach may not be optimal for all servicers, or for all types of outsourcing. For example, new and innovative suppliers may be reluctant to share certain types of information about their operations, believing it may undermine their comparative advantages or that their disclosures may reach their competitors; others may

resist providing financial data without knowing if a contract will be awarded. Still other well-qualified suppliers may decline to respond if they cannot devote resources to preparing responses (or choose not to).

Regardless of how potential vendors are identified, which can range from the casual (asking business partners or competitors for referrals) to formal RFPs, certain criteria are nearly always applicable to the due diligence that precedes vendor selection. These criteria help ensure that hidden weaknesses are not overlooked, while simultaneously giving the servicer an opportunity to evaluate potential vendors' responsiveness and whether they have a shared vision of the type of relationship necessary for successful outsourcing.

What, then, should a servicer look for when considering vendors? First and foremost is subject-matter expertise in providing the desired function. Regardless of any other consideration, a provider lacking knowledge of the subject matter, or lacking experience in successfully providing the service, is not likely to be a successful partner. Gaps in knowledge, out-of-date information and/or disregard of substantive requirements can also lead to derivative liability for a servicer, as became apparent during the robo-signing foreclosure debacle.

Handling the Work, Planning for Contingencies, Licensing and Reporting

Once subject matter expertise and experience are established, the inquiry becomes: Can the vendor handle the work? Suppliers come in all shapes and sizes, from national vendors providing appraisal management to small mom and pop shops that handle lock changes and lawn mowing. Size is not always a reliable indicator of competency. Smaller or local/ regional companies often have a great stake in maintaining their local reputations as they cannot easily pick up lost business elsewhere. On the other hand, a disadvantage to contracting with a large number of local suppliers, as opposed to contracting through national companies, is the necessity of managing many individual vendors and contracts, which can be administratively burdensome. Another consideration applicable to smaller companies is the possibility that they have less robust reporting and technology platforms, which makes it harder for a lender to evaluate their performance. An offset to possible shortcomings, however, could be the local supplier's ability to respond quickly to requests and greater operational flexibility.

However, regardless of whether a supplier is large or small, local or national, its ability to perform the work must be evaluated. National vendors frequently rely on subcontractors, requiring the lender to consider the qualifications of the subcontractors as well as the prime contractor. Extensive use of subcontractors can also lead to higher prices, as mark-ups for both subcontractors and the principal vendor are factored into the contract price. In selecting any vendor, the possibility that the work will expand (or contract) should be considered. If the activity outsourced is expected to grow 10% a year, a

company already stretched to capacity in terms of personnel or facilities, or one whose sole proprietor owner intends to retire soon, may be an unwise choice.

The existence and adequacy of a vendor's business continuity plan (BCP) are vital elements in the evaluation of ability to perform. When a servicer depends on a supplier, an interruption of that supplier's business can have outsized consequences. For this reason, BCPs are important, particularly if the vendor will be performing unique or hard to replicate services or where interruption of services would have significant consequences for the lender or its customers. Due diligence requires careful review of the supplier's BCP as well as how the supplier's previous business interruption events, if any, were resolved, including any consequences to clients.

Another essential area of inquiry for vendors and one that directly affects their ability to perform is proper licensing and permitting. The servicer should understand the types of licenses, approvals and permits appropriate to the vendors it engages. These range from real estate broker licenses to appraiser and surveyor licenses, professional licenses for engineers, architects, attorneys and accountants, and contractor licenses (including specialty subcontractor licenses for tradesmen such as plumbers, electricians, and the like). To the extent these licenses involve periodic renewals or have requirements for continuing education, for example, the proposed vendor should have a documented compliance process.

Intimately related to the issue of a vendor's ability to perform is its ability to report to the servicer. Superior work may never be seen by the servicer—by the same token, unsatisfactory efforts may be hidden from view when a servicer is physically far removed from its suppliers. The reporting function is key to keeping the lender informed about service level achievements (or failures). Vendors should be able to provide reports that are both responsive to their clients' objectives and can be integrated into clients' information-tracking systems. Where complex or high-volume tasks are involved, servicers may require custom reporting, or reporting on platforms of their selection. A servicer should retain the right to audit vendor reporting.

Investigation of Infrastructure, Financial Viability, Compliance Commitment and Reputation

A servicer must consider prospective vendors' infrastructure and related questions, including whether each vendor has the appropriate rights in essential intellectual property such as computer programs, to complete its tasks. Infrastructure varies with the type of work performed, so a document preparation company's infrastructure might be technology-centric, a property maintenance vendor might need mostly workers, tools and trucks, and a real estate broker's infrastructure may consist of trained and successful sales agents with extensive networks of potential buyers and sellers. Regardless of the particular facilities and

infrastructure needs involved, the lender or servicer must be diligent about inquiring what tools are vital to the proper performance of the outsourced work. Diligence would extend to consideration of whether the infrastructure is owned or leased, whether it is of recent vintage, and whether the proposed supplier has established reserves for updating and expanding any required resources.

Servicers should consider the financial viability of their potential suppliers, including not only their own resources, but those available to them in the event of catastrophe, whether based on human error, deliberate malfeasance, or natural disaster. Information provided by the vendor (such as historical financial reports and balance statements) should be verified independently, with CPAs or other analysts, through business credit reports, D&B reports, the company's filed SEC reports and other sources.

A vendor's insurance coverage should be commensurate with the risks involved in its activities, with deductibles and exclusions, both size and type, carefully considered to determine if they present unreasonable risk. The insurance company's own financial rating is not immaterial to this investigation, nor is the claims history of the insured (which may impact its ability to renew its coverage). Indeed, the details underlying insurance claims may be red flags for liability events that other due diligence inquiries might not uncover. If significant claims are based on acts or omissions of company principals, further investigation of these individuals may be warranted. Investigative agencies offer these types of services.

During the due diligence phase, the servicer should also look for information that may not have been disclosed by the prospective vendor, such as regulatory sanctions, fines, penalties and the like. This type of information may be available from the supervisory or licensing authority that issues the vendor's licenses or periodically examines it or from the vendor's own auditing department. Review of the vendor's internal audit reports can be revealing, both before vendor selection and throughout the outsourcing relationship.

Whether a company is committed to compliance will be revealed not only by its reputation in the market, but by its responses to requests for the findings of audits, supervisory reports, and other types of compliance reporting. Companies committed to legal and regulatory compliance will have policies and procedures manuals that describe business objectives and appropriate conduct. Indeed, in highly regulated industries, such as mortgage banking, maintenance of P&P manuals is mandatory for participation in certain programs, such as FHA lending. An absence of these types of tools is a red flag where compliance is concerned. Due diligence on vendors providing customerfacing activities would appropriately include review of customer complaints, including any mechanisms for resolving complaints. Material litigation involving a company, whether based on government enforcement action, or filed by private parties or competitors, is another area to investigate, and the

potential outcomes of such litigation should be evaluated vis-a-vis the company's continued financial viability.

The reputations of prospective suppliers should be investigated and weighed in the vendor selection process. The financial crisis demonstrated how financial companies' own reputations were affected by their association with third parties of compromised reputations. In "the new science of reputation management," it has been observed that "the way in which the outside world expects a company to behave and perform can be its most important asset," with researchers suggesting that even rises and falls in stock prices can be a direct function of the company's public reputation.

Examination of a company's reputation can be as simple and straightforward as an internet search for past media coverage, to a more focused investigation on the company's supervisory examination reports, litigation, and SEC filings in an attempt to identify issues that might emerge in the future. For some companies, the investigation might include research on the backgrounds of company officers and directors. Where red flags are noted, additional inquiry may be in order. Red flags may include items such as company name changes, which could suggest a desire to "start over" with a clean slate after negative publicity. An examination of reputation should also include a determination whether the proposed vendor has had any previous relationships with the servicer, and if so, whether they were satisfactory. Due diligence focused on reputation can easily be expanded to include reference checks with the vendor's prior and existing customers (including calls to customers not specifically identified by the vendor).

Diversity, Innovation, Price and Cultural Compatibility

In their own workplaces, many lenders and servicers focus on achieving and maintaining diverse employee populations, and some also care about selecting vendors with commitments to workplace diversity. Due diligence in this area can help both lenders and vendors by promoting job opportunities, avoiding human resource and discrimination complaints, and enhancing both companies' reputations for being "a good place to work." For vendors deemed to have insufficiently diverse staffs, but who are otherwise well qualified, a probationary period in the outsourcing contract may bridge the gap while greater diversity is achieved.

When servicers outsource consumer-facing functions to third-party vendors, vendors often gain access to consumer data, which can be useful to the servicer as it seeks to develop new products and services, or improve upon existing products, services, or functions. Whether the proposed vendor is innovative can therefore be a potentially profitable area of exploration. Here, the servicer is not merely evaluating what the vendor has to offer visavis its current needs, but is also evaluating intangibles like originality and creativity. The desire and ability to innovate is sometimes a hallmark of newer entrants in various industries, and, in some cases, may partially compensate

for short commercial histories in more traditional undertakings.

It may be surprising that we discuss price close to the end of our checklist. Price, however, can be negotiated, while other elements of the outsourcing relationship, such as commitment to compliance, reputation, and subject matter knowledge are more likely to create legal risk for the servicer. In evaluating potential vendors, a servicer should be aware of general marketplace prices for similar services, to ensure that the vendors considered are in range. Sometimes called price benchmarking, this aspect of due diligence is particularly important where the vendor's costs are partly or completely charged back to consumers, as consumer challenges to third-party vendor fees have created liability for servicers in mortgage-related litigation.

Finally, the selection process should consider whether the servicer and vendor have compatible corporate cultures. Due diligence is an inexact science, intended to elicit information to facilitate good decisions. However, some elements of due diligence are only remotely associated with the likelihood that two parties will achieve a workable relationship. Ultimately, whether a servicer and its vendors can sustain satisfactory relationships that further the outsourcing objectives may turn on the servicer's ability to identify vendors with whom it shares a compatible corporate culture. To achieve this milestone, both servicers and vendors must be able to articulate the values they prize in their markets, and communicate them to each other, before the selection process is complete.

The Checklist

To sum up, a servicer considering outsourcing relationships with third-party vendors should consider whether proposed vendors meet their criteria in the following areas:

- 1. Subject matter expertise in the subject of the contract
- Operational capacity—
 the ability of the vendor to handle the contracted
 work efficiently and to expand quickly to add
 additional services, if required
- 3. Infrastructure and personnel—
 premises and facilities, technology, communications
 infrastructure, and trained personnel (and ability to
 supplement these, if required)
- 4. Financial viability—
 financial strength, credit rating, debt ratios, profitability, including risks to the company's financial position based on competition and/or regulatory developments

- 5. Indemnity and insurance—
 the vendor's insurance coverage and claims history,
 and the financial strength of the insurer
- 6. Commitment to compliance—
 demonstrated commitment to legal and regulatory
 compliance, as revealed by procedures for implementing regulatory changes, absence of significant
 enforcement actions or supervisory sanctions, robust
 mechanisms for resolving consumer complaints,
 and scarcity of litigation alleging noncompliance
- 7. Use of and monitoring of subcontractors
- 8. Business reputation—
 the company's overall reputation in the market in which
 it operates, including the reputations of its principals
- 9. Licensing and approvals—
 the company's maintenance of permits and licenses
 necessary to perform its core mission
- 10. Diversity—
 the vendor's commitment to a diverse staff and workplace
- 11. Reporting capabilities—
 the ability to provide useful and timely reporting, including custom reports on proprietary platforms, if required
- 12. Innovation—
 the ability to produce (or assist with producing)
 new products or services that may benefit the lender,
 based on the data provided or developed in the
 outsourcing relationship
- 13. Price—
 the vendor's pricing relative to those of competitors in its market
- 14. Compatible business culture

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