

## WHY CAN'T WE DO IT RIGHT THE FIRST TIME?

Foreclosure mess underscores importance of competence and adherence to sound procedure and practices.

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Reading this past week about the mess that mortgage foreclosures have become calls to mind the series of lessons that bankers and other lenders seem to have to learn and relearn every 25 years or so:

1. Be suspicious of rapid growth. Rapid growth is often illusory, as lenders don't necessarily keep up with risk measurements and assessments in new product lines or geographies.
2. Prudent banking means prudent risk taking. Prudent risk taking requires attention to detail and a respect for process and procedures.
3. Documentation losses are inexcusable. Most of us who are products of formal training programs were taught as beginners that no losses from documentation deficiencies are ever acceptable. Human beings will make mistakes. But systems are designed to eliminate errors in the process. We are learning once again in the working lifetimes of many of us that inadequate attention to internal controls can be very costly.
4. Sloppy back offices are the equivalent of strategic deficiencies capable of jeopardizing the viability of an enterprise. Technology should be the servant of effective processes. Have we unwittingly permitted systems to become obstacles to proper outcomes by their size and complexity?
5. Various risk categories are often interrelated. They have been shown to be quite concentrated through this painful situation. It seems that the crush of business a few years ago in originating mortgage product for securitization sowed the seeds of what a segment of the industry is facing right now. How significantly did the rush to book loans contribute to short cuts in the paper work?
6. Rapid growth and corners cut now pose significant increases in Reputation Risk, Operational Risk, Regulatory Risk, Compliance Risk, Legal Risk and, indirectly, Credit Risk. Recent speculation by financial pundits suggests that many large mortgage processors may face considerable financial exposure in being unable to show a clear chain of title to collateral assets. The only type of risk that bankers manage on a daily basis missing from this list is Liquidity Risk, and if perception becomes reality, that may follow for some institutions.

### Putting the foreclosure situation in perspective

Perhaps the current situation is not as serious as it seems, and it will work out without too much disruption in the end. Yet the financial costs associated with these shortcomings are very real. Billions of dollars have been at least temporarily shaved off the market capitalizations of major financial institutions and the processing costs of redoing much of the paper shuffle will be very expensive.

One lesson certain to endure is the realization that unidentified business risks often lurk just below the surface. Another is that a cursory evaluation will not show just how concentrated they really can become.

Maybe what we're really looking at in this crisis is a cousin to the "too big to fail" issue. Have some participants driven large-scale transactional activity and fee income in a major business line to the point of unsustainability? Would you call this "too big to succeed," if success is defined as controlling interrelated business risks to produce genuine, sustainable revenue sources from large-scale transactional activity?

In any event, this disruption has caused tremendous uncertainties in the mortgage markets, the ultimate ripple effects of which may not be seen yet. Consider, how is future mortgage lending to be sustained where there is doubt as to the efficacy of the process of obtaining clear title?

Broader implications can be seen

An avoidable mess was been created. How many times do we have to relearn the same lessons? This calls to mind Einstein's definition of insanity: Doing the same thing time after time and expecting different results.

Finally, picking up on the theme of last week's blog, these failures are reflective of unethical behaviors. Some participants did not perform to standard and didn't slow down the process to correct it. The result was not to just flush away much of the prosperity stockholders thought they had achieved in this business line. The reputation of a whole industry has been assailed and assaulted.

Sadly, it seems that we have learned little or nothing in the last 25 years. How is that for a legacy?

About Ed O'Leary:

Veteran lender and workout expert O'Leary spent more than 40 years in bank commercial credit and related functions, working with both major banks as well as community banking institutions. He earned his workout spurs in the dark days of the 1980s and early 1990s in both oil patch and commercial real estate lending.

O'Leary began his banking career at The Bank of New York in 1964, and worked at banks in Florida, Texas, Oklahoma, and New Mexico. He served as a faculty member and thesis advisor at ABA's Stonier Graduate School of Banking for more than two decades, and served as long as a faculty member for ABA's undergraduate and graduate commercial lending schools.

Today he works as a consultant and expert witness, and serves as instructor for ABA e-learning courses and a frequent speaker in ABA's Bank Director Telephone Briefing series. You can hear free audio interviews with Ed about workouts here. You can e-mail him at [etoleary@att.net](mailto:etoleary@att.net). O'Leary's website can be found at [www.etoleary.com](http://www.etoleary.com).