Whitepaper

Riding the third wave of digitization

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Explore key concepts driving the latest digital transformations in the financial services industry

For many financial institutions, the global pandemic was the boost they needed to fast-track the implementation of digital banking processes. By eliminating in-person contact and accelerating the speed and convenience of their lending transactions, financial institutions have made great strides toward a digital transformation.

And while the pandemic's narrative is still unfolding, its impact on financial institutions continues to reverberate throughout the industry. Borrowers now expect, rather than demand, a digital lending experience.

As lenders continue to proactively accelerate their pace of digitization, the question for finance leaders and lenders should no longer be whether to adopt new technologies for digital lending but rather which technologies will best meet their needs now and in the future.

Understanding the priorities of regulators is another key component of proactive compliance. Regulators want to see a solid, fully functioning framework in place that guards against risk and other compliance problems before they happen.

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First wave drivers:

Digitization of front-end processes including loan application and underwriting.

2

Second wave drivers:

Necessity of fully digital loan closings.

Riding the digital wave

Over the last few years, financial services organizations and lenders have experienced three waves of digital transformation—with each wave driving fundamental process and technology changes. The first wave was primarily customer experience-driven. Borrowers wanted their lending transactions to mirror their retail transactions over the internet. As broad internet infrastructure became available, the digitization of front-end processes, such as loan applications and underwriting, became achievable.

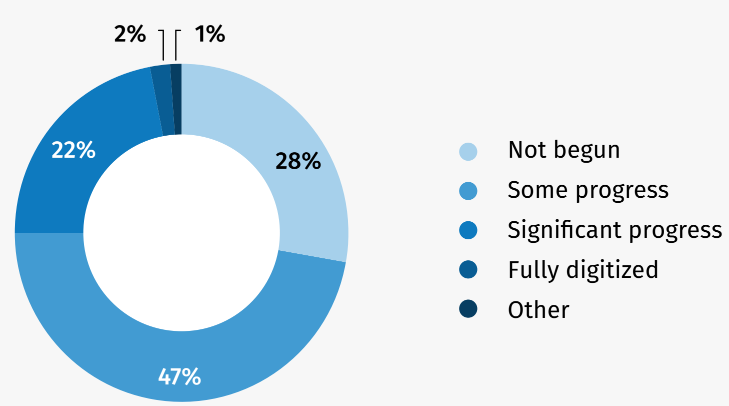
While digital adoption was slow and incremental in the first wave, the second wave hit like a tsunami. Although the pressure for financial institutions to meet the growing demand from borrowers for a fast, seamless, and transparent experience had been on their radar long before the global pandemic hit, the crisis exposed gaps in many financial institutions' ability to quickly adapt to meet rapidly changing market pressures and evolving client expectations.

At the pandemic's onset, the swiftness of business shutdowns and the need for social distancing turned banking on its head. Suddenly, the highly paper-intensive, face-to-face lending processes needed to be digitally enabled—and quickly. With so many unknowns, the pandemic created an urgency for lenders to speed up their digital transformation to support fully digital loan closings, including remote online notarizations, settlements, and back-office operations.

Accelerating your digital transformation through emerging technologies can be an opportunity to expand your reach and capture new revenue growth—at a lower cost. Wolters Kluwer conducts an annual Regulatory & Risk Management Indicator Survey to identify regulatory and risk management trends, determine the regulatory impact on financial institutions, and assess the state of risk management efforts. As the demand for digital experiences intensifies, 47 percent of the respondents in this year's survey say they've made some progress with digitizing their lending capabilities. In comparison, 22 percent say they have made significant progress and an enviable two percent have fully digitized. Looking ahead to the next 12 months, 63 percent anticipate "significant" or "some" acceleration of their organization's digital lending processes.

As the third wave of digitization emerges, technology is now a competitive necessity. Financial services organizations and lenders who proactively embrace digitization will ride the wave to improved compliance and risk mitigation, lower origination costs, and greater consumer engagement.

Progress with digitizing lending capabilities



Source: Wolters Kluwer 2021 Regulatory and Risk Management Indicator Survey

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Third wave drivers:

Risk management requiring regulatory and best practices processes across the asynchronous, multi-party processes and technologies utilized for each lending transaction.

Three key third wave concepts

- Transition from reactive to proactive compliance management
- Compliance-first product development
- System-level compliance

Key concepts: Riding the third wave of digitization in financial services

The three key concepts that drive the third wave of digitization—transitioning from reactive to proactive compliance management, compliance-first product development and innovation, and system-level compliance—are all centered around enabling digital lending technology value while mitigating ongoing compliance risks. Most importantly, the third wave is imperative for financial institutions, not an option.

Transitioning from reactive to proactive compliance management

Keeping current with changing regulations consistently ranks as a top challenge for Regulatory & Risk Management Indicator Survey respondents, no matter the lender type or asset size. The survey also asked how concerned respondents were with their ability to maintain, demonstrate, and manage compliance risk. While the numbers have remained the same or ticked down slightly over the last few years, over 50 percent of the respondents continue to rate themselves as very concerned in each of the critical compliance and risk management areas.

Compliance should be viewed through a consumer-centric lens and positioned as a competitive advantage throughout the organization. It is critical for organizations to have a clear, measurable definition of their risk tolerance. Financial institutions should know where and what their risks are and take ownership of them across the organization.

Understanding the priorities of regulators is another key component of proactive compliance. Regulators want to see a solid, fully functioning framework in place that guards against risk and other compliance problems before they happen. Controlling and preventing problems holistically through the three lines of defense and a well-established, integrated compliance risk management framework is foundational to proactive compliance.

Compliance-first product development and innovation

The second driver, compliance-first product development and innovation, requires a shift in mindset. Compliance cannot be an afterthought in developing a digital lending solution. If it is, the risk of reengineering, delaying, or even abandoning the product is high.

Therefore, starting your digital journey with compliance top of mind is critical. What does that mean? Organizations should consider every workflow, process, or system touchpoint and ensure they understand each of the unique compliance requirements and the risk tolerance for noncompliance for those areas.
For example, if an organization is tasked with digitizing its loan process, the compliance requirements don't end when the loan is closed. The organization must also consider the consumer, business and capital markets partners, software development, deployment, support, security, and data privacy. Each area has compliance requirements that must be factored into any innovation. Long-term, compliance-centric innovation in an increasingly complex and regulated lending landscape demands more robust capabilities, such as machine learning-enabled lending compliance technology, to achieve success.

Regulators also expect compliance to be steel threaded and integrated throughout the entire product lifecycle from ideation and design to deployment and post-closing. With true compliance-first product development and innovation, a financial institution gains the confidence that its lending solutions will withstand regulatory scrutiny.

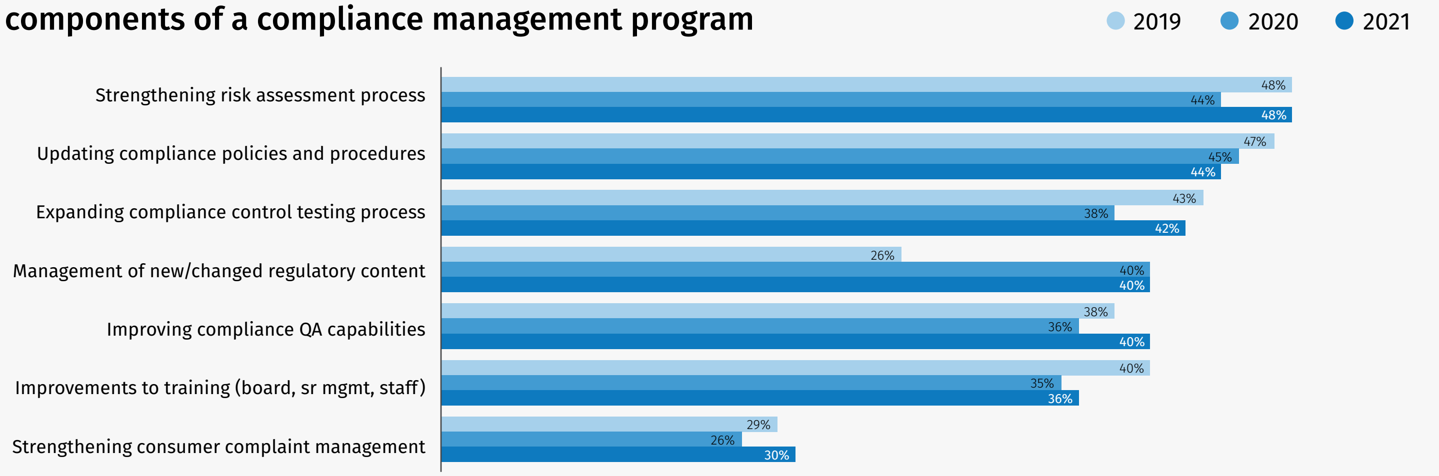
System-level compliance

Like their paper predecessors, digital loans are subject to strict regulations that aim to mitigate risk and ensure legal compliance. A digital loan can last up to 30 years and be in the possession of multiple parties during its lifetime. It may be pledged, transferred to a custodian, sold more than once, or become part of a securitization pool. The validity of a digital loan must be safeguarded throughout the entire loan lifecycle.

Digital transactions introduce additional compliance requirements unique to the digital process. Therefore, it is insufficient to simply apply technology to a traditional process. Developing compliance at the core gives financial institutions more robust insight into their lending business and enables digital asset certainty.

Consequently, digital asset certainty provides assurance that there is an auditable and tamper-proof digital chain of custody for all loans originated electronically, as well as legal standing proving these digital loans comply with the three enabling laws that govern digital lending: Uniform Electronic Transaction Act (UETA), Electronic Signatures in Global and National Commerce Act (ESIGN), and Uniform Commercial Code Section 9-105 (UCC 9-105), including the six Safe Harbor provisions that shift the burden of proof from the lender to the borrower.

Respondents anticipating high investment in the components of a compliance management program



Source: Wolters Kluwer 2021 Regulatory and Risk Management Indicator Survey

Develop and maintain a robust Compliance Management System

Compliance is a perennial concern for heavily regulated financial institutions—including banks, lenders, securities firms, and insurance companies. Among their top regulatory worries? According to the [Regulatory and Risk Management Indicator Survey](), maintaining compliance with changing regulations (56 percent), keeping track of regulatory changes (53 percent), and demonstrating compliance to regulators (52 percent) are what's keeping lenders up at night.

And as an organization grows, keeping everyone on the same page becomes even more challenging. To ease that burden, lenders must have an enterprise-wide compliance focus. This means putting a robust, proactive Compliance Management System in place to ensure you understand what laws, rules, and regulations apply to your organization. Mapping the regulatory library to your internal policies, procedures, risks, controls, products, services, organizational units, and other elements of your compliance program is critical and expected, regardless of the institution's size.

Looking ahead, new rules and regulations will continue to put pressure on financial institutions and strain existing regulatory change management programs. The top four components of a compliance management program where [Regulatory and Risk Management Indicator Survey]() respondents anticipate making high investments are strengthening risk assessment processes, updating compliance policies and procedures, expanding compliance control testing processes, and managing new or revised regulatory content.

Examiners expect financial institutions to maintain a framework for addressing all compliance responsibilities. With dispersed workforces, remote access to customers, and the addition of pandemic-driven regulatory obligations, such as the CARES Act, a robust Compliance Management System (CMS) is more critical than ever. A CMS review can be helpful to evaluate whether compliance responsibilities are being adequately addressed, including:

- Real Estate Settlement Procedures Act (RESPA)/Regulation X
- Truth in Lending Act (TILA)/Regulation Z
- Electronic Funds Transfer Act (EFTA)/Regulation E
- Fair Debt Collection Practices Act (FDCPA)
- Homeowners Protection Act (HPA)
- Fair Credit Reporting Act (FCRA)/Regulation V
- The Equal Credit Opportunity Act (ECOA)/Regulation B and Fair Housing Act
- Servicemembers Civil Relief Act and Interagency Guidance on Mortgage Servicing Practices Concerning Military Homeowners with Permanent Change of Station Orders

Additionally, lenders must ensure their regulatory change management process properly connects to the rest of their compliance program. When a new law, rule, or regulation is released, the financial institution has to jump on it quickly and assess its potential impact across the enterprise. That means engaging key stakeholders immediately, assigning roles and responsibilities, and implementing a process to operationalize the change. Automation provides your compliance team with the ability to analyze regulatory changes holistically and collaboratively while filtering out the noise from the regulations that have no impact on your financial institution.

Regulators' expectations also extend to third-party providers. Third parties may present elevated risks to lenders and their borrowers. Select third-party providers with a rigorous compliance management system that operate in a safe and sound manner, and then monitor your providers closely.

Lastly, product information transparency to facilitate comparison shopping and a better understanding of product features are fundamental to consumer protection law. Make sure pricing and terms are transparent, and most importantly, always act in the best interest of borrowers. Promoting and selling lending solutions in a way that doesn't reveal their nuances in prices and terms can give rise to serious compliance problems.

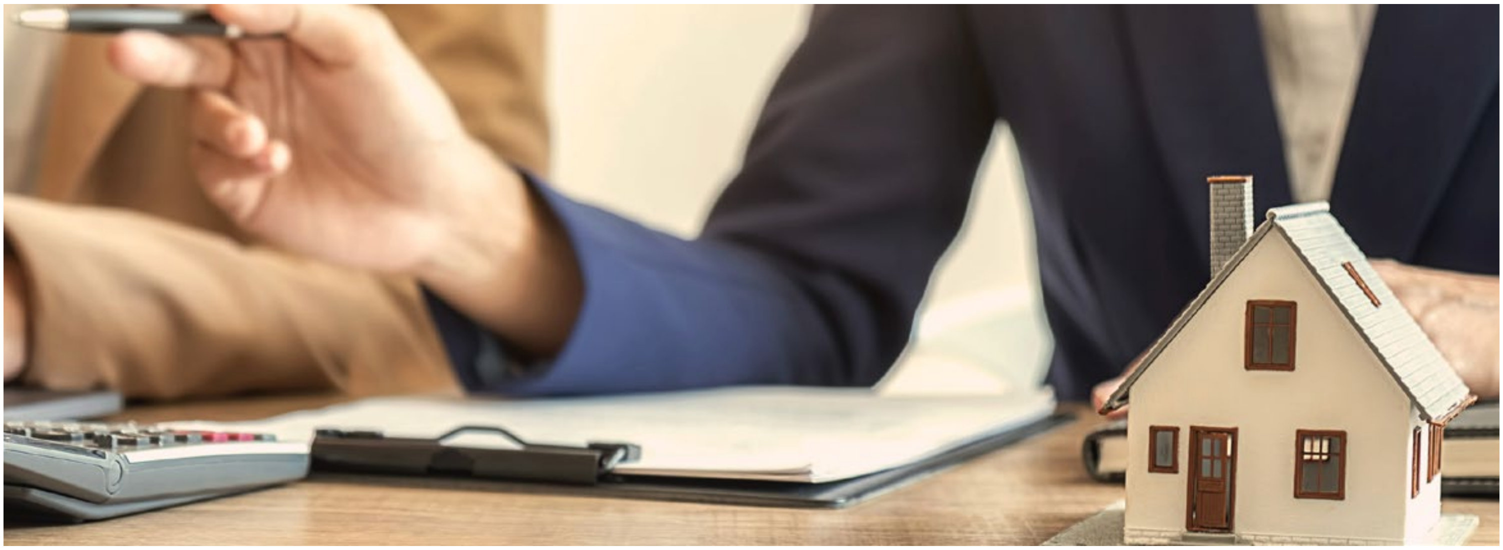
Technology is essential to protect consumers

Many financial institutions still heavily rely on manual, paper-based processes despite tremendous strides toward digitization. Eighty-seven percent of the respondents in our [Regulatory & Risk Management Indicator Survey]() are still using manual processes or spreadsheets at least some of the time for their compliance management efforts, which more than likely include tracking and maintaining new and changing regulations and collecting, analyzing, and reporting on required regulatory data. Respondents cited manual processes as the top obstacle to implementing an effective compliance management program in a separate survey question.

As more financial institutions catch the third wave, manual processes will be replaced with automated workflows that provide real-time performance tracking, error notification, audit logs, and reporting. Additionally, digitization allows financial services organizations and lenders to be more proactive and preventative by freeing up resources and empowering compliance teams to find the root cause of non-compliance, rather than just putting out fires.

Lenders also want to deploy analytical tools to review lending patterns. For example, analytical tools can help evaluate Community Reinvestment Act (CRA) performance to detect fair lending compliance problems. These types of tools help lenders identify how well they are serving the needs of low-to-moderate-income borrowers in their assessment area. Tools that can map application and loan data help identify any potential gaps in compliance and pinpoint new areas where lenders might expand services to increase fair lending performance and mitigate risk.

Borrowers have come to expect a mobile and remote experience. Lenders must offer that experience with the same or greater level of compliance and satisfaction than they would on paper, in person, or on a larger screen. Recognize that security and compliance go hand-in-hand. Establishing strong "Know Your Customer" identity verification and borrower information protection technologies, along with general information security practices, are a must to protect financial institutions and their borrowers against fraud and privacy concerns.



Regulators stance on digitization

Regulators have always welcomed the power of technology for conducting examinations, with examples going back decades of using tools to verify annual percentage rates. Now, at a much more sophisticated level, financial institutions are witnessing regulators embracing technology and encouraging organizations to use it to help identify problems before they become violations. This is particularly apparent with anti-money laundering programs, the Bank Secrecy Act, and even with simpler things like a missing signature on a closing document.

Regulators are also looking at digitization as a tool to advance diversity, equality, and inclusion in delivering financial services. While digitization opens the door to credit access for many, it carries additional risks that need to be managed and may require further regulation and exam scrutiny to protect consumers from harm. Lenders can ensure they stay abreast of where the regulatory community stands on digitization by reading the bulletins, supervisory publications, speeches, and congressional testimony that regulators release to ensure top priorities are understood and to manage compliance effectively.

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Final thoughts

The global pandemic has only accelerated lenders' move toward digitization, with growing consumer demand and regulatory expectations focused on what happens next. Meanwhile, concerns about risk continue to be top-of-mind.

Financial institutions need to be vigilant about having robust regulatory change management programs in place and fully functioning Compliance Management Systems with current policies and procedures. As managing compliance becomes more complicated—and institutions face a more rigorous supervisory climate—financial institutions will have an even greater need to embrace technology that replaces manual processes and outdated reporting practices. Developing a disciplined, automated approach to compliance efforts now will provide the consistency, transparency, and security that regulators require and consumers demand.

Wolters Kluwer is the leading provider of digital loan compliance technology and services, from origination to monetization. We offer the industry's most trusted solutions to navigate the ever-changing regulatory compliance landscape. For more information on world-class compliance expertise, solutions, and services from Wolters Kluwer and our partners, please visit https://www.wolterskluwer.com/en/compliance

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