

Following A Paper Trail To High-Quality Hedging

Document compliance and a studious post-close review process can build intelligent portfolio development and bolster hedging strategies.

By Mary Kladde & Curt Doman

Hedging allows mortgage bankers to balance their interest-rate risk for the duration of the origination-through-purchase timeline, and to offset loan fallout. Strategies for anticipating and responding to myriad pipeline value risk scenarios range from simple to downright complex (which is why most mid-tier mortgage bankers outsource secondary functions beyond that of a standard lock desk). At the end of the day, hedging strategies share a double-edged goal: Manage what is predictable while being prepared for what isn't.

For secondary marketing - and, in fact, for the whole mortgage lending enterprise - it is preferable to have all loans perform as predicted. In such a world, loans arrive perfectly at their investor destinations, in a profitable pool, where they are purchased without pending conditions and are never heard from again, except for a thank-you note from the borrower.

To the extent they can reach that goal, lenders are rewarded with better margins for selling pooled loans - also known as bulk mandatory - versus individual loans, and their loan pipeline accelerates. Achieving flawless loan performance with maximum consistency is hedging in its purest and most transparent form.

Many lenders have come to rely heavily on their loan origination sys-

tem, underwriting and compliance automation protocols to support loan-level performance objectives. Although these systems can include a strong first line of defense, there are gaps that can prove to be lethal. Recently, these gaps became evident when lenders encountered the difficulty of handling disclosure-related regulatory changes and managing frequent exceptions to the new rules.

Fortunately, there is a second and less porous line of protection closer to the point of sale with investors where lenders can still intercept errant loans before they compound pipeline risk.

This year, the Real Estate Settlement Procedures Act (RESPA) became the poster child for well-meaning but unruly public policy that burdens the industry with unintended consequences. It is not radical, or even particularly debatable, to summarize the impact of the new good-faith estimate (GFE) and HUD-1 as having made mortgage lending more complex (e.g., more time-consuming).

Although documents have always been elemental to mortgage lending, as a product of RESPA reform, they have become far more than that in the end stage of perfecting a loan.

The issuance of correctly executed, up-front disclosures is mission-critical because, according to RESPA, the GFE cannot be altered except under limited conditions.

Furthermore, neither the GFE nor the HUD-1 has a meaningful relationship with the Truth in Lending Act, which has prompted the unsanctioned but recommended use of informal "worksheets" to improve clarity for the borrower. Thus, RESPA has made a minefield of disclosures and closing documents.

Therefore, unless RESPA is repealed or reformed, lenders' loan document packages will carry the same potential to derail a loan's salability or a pool's conformity as sloppy underwriting or other regulatory noncompliance. Further, investors have upped the ante for the delivery of compliant loan files - including disclosures and closing documents - and are not in the mood to overlook discrepancies.

As economic principles would have it, when a product is in demand and supply is scarce, the cost rises - in this case, the investor standards for loan quality.

Now is a good time to assess the quality, reliability and scope of lenders' document-preparation solutions. Ideally, the document preparation provider has demonstrated its mastery of RESPA-related disclosures and re-disclosure guidelines. Expert

rules-based document-preparation systems are the engine for creating compliant loan packages, but equally important is the flexibility to create a custom document that fulfills a specific investor requirement.

Pre-purchase reviews

The net impact of ill-fitted regulatory changes and investors' heightened risk sensitivity has been to slow lenders' mortgage origination pipeline to a veritable crawl. Add to that the persistent issues related to warehouse lines and lender liquidity. Because risk mitigation and liquidity both respond inversely to the length of the loan life cycle from origination to secondary, it would be ideal to accelerate processes and compress timelines.

Nonetheless, when lenders take the relative modicum of time required to conduct loan-level review of every file set for investor purchase, they virtually eliminate for all practical purposes the possibility of a loan returning for clearance of pending conditions. Even when a dubious loan is submitted to its investor, post-closing loan review can help lenders know in advance what it will be pended for so that when the purchase pend comes, it is ready for resolution.

The most common errors caught during the post-closing/pre-purchase review are those that involve a settlement agent for closing and funding. In addition, title errors persist due to an archaic, error-prone process. There is a persistent struggle due to title companies', lawyers' and escrow companies' lack of true understanding of the whole loan process and resistance to adhering to new regulations as dictated by purchasing investors instead of their own interpretation of the regulation changes.

Settlement agents continue to lack

the insight to understand that salability to the purchasing investor - not disbursement - is the end goal for every mortgage lender they serve. Settlement agents need to understand and actively strive toward this end goal.

Even though economic and regulatory conditions are conspiring to thwart it, lenders must keep their eyes on the goal of getting through the loan life-cycle obstacle course in the shortest time possible while ensuring the salability of their loans. Simple process improvements can allow lenders to make great strides toward loan life-cycle compression.

In addition to process improvements and adjustments, automation is also helping compress the supplemental time created by new requirements and forms, but until the industry can better manage exceptions, push for standardization and bring more uniformity across purchasing investors and their interpretation of government-sponsored enterprise loan-quality requirements, pipeline risk will persist at a much higher level than experienced prior to the economic meltdown. And make no mistake - these new regulations are not going away.

Changing times

In time, mortgage lending process acceleration will fundamentally change the industry's risk profile and promises to transform residential real estate finance for good. Enabled by rules-based workflow automation, ubiquitous business-to-business connectivity and advances in the secure exchange of financial data, the mortgage loan life cycle is positioned for significant compression.

As discussed, among the primary benefits of shortening the route from origination to investor purchase of a

mortgage loan are a decrease in interest-rate risk exposure and an improvement in liquidity - due to no-glitch investor transactions and rapid turn times on warehouse lines.

Complex hedging strategies may possibly wane in importance as a by-product of accelerated mortgage lending processes, but the benefits of document compliance checks and 100% pre-purchase loan review will persist as commonsense risk management strategies. The industry should anticipate further truncation of the mortgage lending process and realize that a recalculation of risk management priorities is inevitable.

The net effect of lending life-cycle compression will be most noticeable in mortgage hedging strategies, which will naturally shift from diversified instrument strategies aimed at balancing interest-rate risk to a focus on total loan quality and absolute salability. In a world where process acceleration and zero-defect loan files substantially minimize mortgage lending risk, independent mortgage bankers can hope to transform a largely defensive and, as of late, typically unstable business model to one that is driven by and adheres to financially responsible principles.

Whether executing complex, multi-faceted hedging strategies or simpler ones, attention to detail in the documents package and a commitment to granular post-close/pre-purchase loan review is a formula for success. **SME**

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