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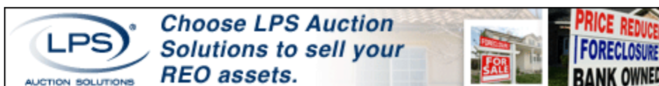

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Restoring Trust And Reducing Risk With Loan-Level Reviews

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BY MARY KLADDE ON THURSDAY 18 AUGUST 2011

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***REQUIRED READING*: Perhaps there was a time when mortgage lenders, their investors, their warehouse-line providers and servicers could afford to do quality checks on as few as 10% of the loans that they sold, bought, backed and agreed to service - just as there also may have been a time when U.S. airports could afford to screen only one out of every 10 passengers or only one-tenth of all carry-on items.**

Indeed, we live in times where previously safe assumptions have been found to carry unconscionable risk. Whether, in retrospect, we've left behind better days when trust was a hallmark of our business, or simply experienced the harsh downside of calculated risk-taking, we cannot return to yesterday's mortgage quality calculus.

Thus, it is deeply important for secondary marketing professionals to accept a role in re-calibrating our industry's standards with regard to loan quality. At both the strategic and operations levels, a mortgage lender's secondary marketing officer typically has the more holistic perspective on how the mortgage banking industry functions.

Minus an investor market, the mortgage economy will shrink to the point of losing its relevance. Without warehouse lenders, only community-bank mortgage lenders will have liquidity, weakening competitive opportunity. Without servicers, community-bank and independent mortgage lenders must add untenable servicing costs to their profit models.

The residential mortgage finance ecosystem can be self-supporting and vital only to the extent that it prudently seeks, identifies, understands and accommodates varying levels of risk. Risk analysis and mitigation have proven to be our industry's Achilles' heel, and there is really only one orthopedic option: We must acknowledge that, due to the complexity of residential mortgage finance, our product is subject to sometimes arcane, sometimes careless error that must, nonetheless, be ferreted in order to understand risk.

Performing loan-file review periodically throughout the mortgage lending life cycle is an industry best practice that should become an industry standard practice. For some stages of the life cycle, the loan-level review - the examination of specific data points in the loan file - is adequate to determine compliance.

Warehouse lenders, for example, have a vested interest in whether the loans they will carry for a few days contain errors that might stall their purchase. Servicers will likely want to get an updated read on borrower credit scores when they take on a file.

However, for the lender-investor transaction, it is more appropriate to conduct a whole loan purchase review (WLPR). WLPR protocols address the investors' dual objectives: to purchase quality loan product and to manage productive relationships with their correspondents.

Conducting a WLPR allows correspondent investors to be more successful in the conventional market, delivering directly to Fannie Mae, Freddie Mac and Ginnie Mae. Committing to a WLPR also offers correspondent investors the confidence to explore new funding sources through private securitization in a transparent, well-regulated, compliance-centric environment - a market poised to innovate in an era beyond the current government-sponsored enterprise setup.

A WLPR dives deep to ensure that discrepancies and deficiencies - as they relate to the documentation, compliance, insuring and sale and/or boarding for servicing of a loan - have been identified and corrected as necessary prior to actual funding/purchase. In an ideal world, a WLPR verifies loan quality both pre-funding and prior to purchase.

Also, a WLPR offers lenders and investors asset protection, salability-compliance correction and a more efficient loan purchase process. As a standard operating procedure, a WLPR generates accredited pools of higher-quality loans that perform more profitably, conceivably opening the doors to provide support for a new, aggressive securitization business model.

Cover your assets

In addition to conducting the relevant levels of loan review, participants in the residential mortgage lending life cycle must also rethink their assumptions about what constitutes a "representative sample" of loan review relative to the risk represented. Commonly, the industry has sampled 10% of loan production for quality and compliance purposes. There is mounting evidence that significantly higher sampling will both mitigate buyback demands and help isolate troubled lenders.

In March, a U.S. Inspector General's audit of 15 Federal Housing Administation (FHA) lenders uncovered a convincing case for executing WLPR prior to investment, supporting the standardized practice of loan-level review and rethinking "statistically valid samples" as it applies to the post-meltdown environment. As a consequence, 15 mortgage lenders are facing $23.4 million in potential fines for improperly underwriting FHA-insured loans, and the U.S. Department of Housing and Urban Development (HUD) stands rebuked for failing to "verify independently that loans met FHA requirements and were eligible for insurance."

The Inspector General's report cites HUD's failure to detect loans destined for default based both on non-compliant production and early performance indicators that eventually caused an $11 million hit for the FHA insurance fund. In light of mounting losses to the FHA insurance fund, which is on its knees under the weight of terminal mortgage loans, it is helpful to understand how this came to be.

According to the report, "[L]enders failed to comply with even the most basic of underwriting requirements. Half [of] the 284 loans reviewed should have been disqualified, because the lenders did not properly calculate or verify the borrowers' income or employment, did not properly document the source of borrowers' funds to close the loan, or did not properly assess the borrowers' financial obligations."

If compliance failures were noted on half of the 284 loans reviewed, just imagine if all of them had been reviewed. The FHA was a significant source of 2010 funding. Fewer than 300 loans from 15 FHA lenders is, to be charitable, rather miniscule.

According to the Inspector General, "HUD's current method of selecting FHA loans for review [is] based on a statistically valid sample of loans with various risk factors." Further, the report observes, "This method does not ensure that all claims are reviewed and may not target sufficient loans with claims paid to reasonably protect the fund."

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Everybody gets burned

Clearly, lenders and investors who refuse WLPR post-closing and pre-purchase are not serious about being in this business. Further, warehouse lenders and servicers have a vested interest in knowing more about the loans upon which their business model is built.

Today, the servicing side of the mortgage lending life cycle is fully embroiled and under fire from lawmakers and regulators for behavior that looks on the surface either like incompetence or negligence. Of course, like lenders, servicers are taking exception, but if they think they will escape accountability for their role in collecting profits on ill-conceived loans, they are wrong.

Warehouse lenders are, for the most part, cognizant of their risks, because they were decimated by an assault on their capital after the market collapsed in 2007 and 2008. Regardless, no one will escape costs and liability for the way that nonperforming loans are mitigated or resolved.

Implementing loan-level review prior to putting a loan on a warehouse line or at the time of assignment for servicing does not necessarily imply turning away business. It could involve adjusted fee pricing for loans that do not emerge squeaky-clean. It could also involve sending them back to the originating lender for correction when possible. Loan-level review by warehouse lenders and servicers would not only protect their business from future liability, but also add a new stream of fee income for intercepting non-compliant loans early.

To many people, our industry's problems come across as complex, daunting and tedious to resolve. But when one takes a few steps back and looks at the bigger picture, two truisms seem to apply. One is that the simplest solution is quite often the best, and the other is that the value of trust is trumped by the concept of "trust but verify."

A loan-level review conducted at the appropriate degree for the loan life cycle and redefining "representative sample" in light of what is actually at risk strikes a promising balance that could restore our industry before the regulators ruin it - and we need secondary marketing professionals to help carry the banner.

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