Buyback Prevention

BY LEONARD RYAN

It has been nearly two years since the mortgage industry began struggling with liquidity, default and credit problems. In that time, home prices and loan application volumes have dropped significantly. The National Association of Realtors® (NAR), Chicago, reported in July that the median price of houses sold dropped 6.1 percent during the one-year period from June 2007 to June 2008—the fifth-largest year-over-year drop on record. ■ As a result of widespread credit quality problems, investors have increased their request of loan repurchases, or buybacks, causing some lenders to fold and adding to the liquidity crunch. Buybacks have been on the rise for many reasons. Falling home prices, lax underwriting standards, increased defaults and fraud have all combined to increase the number of buybacks and the willingness of investors to preemptively scan portfolios for non-compliant loans. ■ At the same time, lawmakers and regulatory agencies are responding to a public outcry to address the issues by proposing and passing new laws and regulations. These regulations dictate the origination processes and standards that loans must comply with to ensure the borrower can repay the loan based on information available at the time of purchase. Automated compliance can help lenders reduce financial loss by minimizing the risk of buybacks, better serve their borrowers and continue to maintain steady business during tough economic times.

Buyback demands from investors have cost the mortgage industry real money in recent times. Careful attention to compliance prior to funding can prevent some of these costly problems.

REPRINTED WITH PERMISSION FROM THE MORTGAGE BANKERS ASSOCIATION (MBA)

Why investors return loans

Buybacks, in essence, are like returning defective merchandise to the store. The manufacturer guarantees that the product will perform as advertised, and if the item breaks down within a set amount of time, the buyer can return it for a refund. Buybacks are lenders' guarantee to investors that the loans they are purchasing conform to all government regulations and have a strong chance of being repaid.

Typically, loans can be returned to the lender for repurchase for two reasons. The first is when the loan goes into default a short time after sale, generally within the first three to six months. Investors can also force buybacks if the loan violates the representation and warranties regarding the characteristics of the loan—such as compliance with law, completeness and accuracy of loan documentation, absence of fraud, correctness of appraisal, or proper underwriting. In some cases, investors are using compliance-review systems to cross-check purchased loans for regulatory violations.

Larry Platt, financial services practice area leader for the Washington, D.C.–based law firm K&L Gates LLP, says, "If a seller has breached its representations and warranties regarding the characteristics of the loan, the sales contract usually permits the buyer to demand the repurchase of the loan by the seller, although in many cases the breach must be material. In extreme cases some regulatory violations can void the loan, giving a reason to force a buyback."

Buybacks have proven to be one of the most costly realities of the current mortgage market.

"When someone returns a TV or computer to the store, the cost is fairly low, and the business can absorb the repurchase without much trouble," says Ellen Marshall, a partner with the national law firm Manatt, Phelps & Phillips LLP, based in the firm's Costa Mesa, California, office. "Loans are much larger, and a company can be on the hook for several million dollars with just a handful of returns."

Marshall adds that most requests for repurchase result from errors in documentation. Traditionally, lenders would have no trouble repurchasing the loan, correcting the documentation and then reselling the loan on the secondary market again. As the secondary market has withered, lenders find there is no place to sell loans outside of the government-sponsored enterprises (GSEs), limiting the salability of subprime, nonconforming or jumbo loans.

When lenders are hit with repurchase requests, one of three things happens. First, lenders and investors settle claims for small payments as opposed to a full repurchase. "The goal in a claim settlement is to maintain liquidity," Marshall says. "It is often easier to repay the difference in value on a loan if it can be repaired and still collected."

But the question remains: What role does compliance play in preventing buybacks?

The second option for buyback requests is beginning an investigation, which might ultimately lead to negotiation or litigation to determine whether a loan is truly in violation of its representations and warranties. The third and most dramatic option occurs when a lender cannot afford buybacks and is forced to close its doors.

The rise of buybacks

While investors have always had the right to demand buybacks, it has only been in the past two years that the volume of requests has reached a point that caused financial harm to lenders. In the summer 1998 issue of the Federal Reserve Bank of San Francisco's *Community Development* publication, the article "Credit Scoring and the Secondary Market: Perception, Policies, Practices" discussed the issue of loan repurchases with executives from Freddie Mac and Fannie Mae.

Robert Englestad, then senior vice president for credit policy for Fannie Mae, was quoted in the article as saying that in 1997, "We had approximately one repurchase for every 1,000 mortgages that Fannie Mae purchased. Also, we do not require repurchases of mortgages for underwriting reasons as long as the mortgage is not delinquent."

Today, the story is very different.

"During the good years, investors had things to do other than scrub their portfolios for underwriting problems," Marshall explains. "They would only examine loans when they defaulted to see if there was a basis for repurchase. When the rate of defaults started rising and investors were stuck with worthless loans, they began proactively scanning portfolios for reasons to force a buyback," she says.

Because mortgage repurchases are not always reported, exact numbers on how many loans nationwide have been returned for buybacks are difficult to find. The experiences of some large lenders, however, speak to the rise in buybacks affecting the industry's bottom line.

In its May 12, 2008, 10Q filing with the Securities and Exchange Commission (SEC), Calabasas, California–based Countrywide Financial Corporation stated that the estimated liability on buybacks was $935 million at the end of the first quarter—an increase of 156 percent over the same time during the previous year.

The role of compliance

But the question remains: What role does compliance play in preventing buybacks? The key is prevention.

"When it comes to buybacks, existing loans are already in the hands of the investors," says Stephanie Ochoa, a consultant with Irvine, California–based Ochoa & Associates.

"However, by using various available tools to ensure compliance with state and federal laws and regulations, investor requirements and state regulator-issued guidance prior to funding, lenders can greatly reduce the chance of loans being presented for repurchase," she says.

Most regulations have traditionally addressed one of two things: 1) Regulations either ensure the borrower is completely educated and aware of the terms of the loan; or 2) they protect the borrower from discriminatory practices. Many of the newest regulations being proposed and adopted add a third responsibility—a responsibility of the lender to determine loan suitability.

Anti-discriminatory regulations, such as the Home Mortgage Disclosure Act (HMDA) and the Community Reinvestment Act (CRA), generally do not affect buybacks, because the lender is evaluated on its overall performance and practices concerning fair treatment of loan applicants—instead of being held responsible for individual loans.

However, regulations protecting borrowers from predatory lending practices may contain provisions that allow the investor to force a buyback if the loan is not in compliance. There are a few new and proposed regulations all lenders will need to account for to ensure that every loan meets the new standards and the lender is protected against buybacks.

Regulation Z requires income analysis

On July 14, the Federal Reserve Board of Governors adopted tighter regulations for Regulation Z, which governs the Truth in Lending Act (TILA) and Home Ownership and Equity Protection Act (HOEPA). According to the Fed's Web site, the rule establishes a new category of higher-priced mortgages that "will capture virtually all loans in the subprime market, but generally exclude loans in the prime market."

The updated rule prohibits lenders from making a higher-priced mortgage without taking into consideration the borrower's ability to repay the loan based on income and assets outside of the home's value. The new regulation also restricts prepayment penalties and eliminates stated-income features on these higher-priced loans.

For prime loans, the new regulation also requires Good Faith Estimates detailing the loan costs sent within three days of the application secured by the borrower's principal dwelling, prohibits coercing appraisers to misrepresent the value of a home and dictates how loan payments must be credited by servicers.

"The key to the increased TILA requirements is to put a process in place that ensures all disclosures are sent and received on time," Platt says.

The new rules go into effect for all applications beginning in October 2009, but lenders will need to adjust how they underwrite and classify loans now, as a wider net of loans will be subject to regulation under higher-priced lending rules. More loans will also be subject to income analysis, with borrowers having to document their ability to repay the loan in order to reduce lending exposure.

"Going forward, lenders and borrowers will be required to go through the extra steps of providing third-party documentation for the higher-priced loans," Ochoa says. "Those borrowers will be responsible for providing accurate documentation exhibiting their ability to repay a loan, and lenders will be responsible for analyzing the third-party information to make an informed decision regarding ability to repay," she says.

New federal housing bill changes disclosures

Congress is also getting involved by approving the Housing and Economic Recovery Act of 2008. The measure is designed to provide resources for homeowners currently in foreclosure and establish guidelines to prevent future foreclosures, among other things. On July 30, President George W. Bush signed the legislation into law.

The key regulatory impact for lenders is another expansion of TILA. This provision expands the types of home loans subject to early disclosures, including refinancing applications. The law requires lenders to provide borrowers with the disclosures within three days of the application and no later than seven days prior to closing. It also requires lenders to inform borrowers of the maximum monthly payment possible under the terms of the loan.

"The key to the increased TILA requirements is to put a process in place that ensures all disclosures are sent and received on time," Platt says. "Borrowers who do not receive disclosures can sue to have a loan rescinded for up to three years after signing the loan."

State regulations complicate the picture

In addition to the federal regulations and laws, each state has its own regulatory agencies and laws governing lending practices. According to the American Financial Services Association (AFSA), Washington, D.C., more than 6,300 state bills affecting mortgage lending were introduced between January and July 2008—an estimated 37 percent increase over the total number of state bills introduced during all of 2007.

A timely example is the recent law passed in

California that requires lenders and brokers to provide Form RE 885 to nontraditional and subprime applicants. This law requires lenders to provide a disclosure that compares different loan scenarios using the borrower's proposed loan amount.

To magnify the potential changes, each piece of state legislation normally has more than one change. To magnify the impact even more, the definitions of terms are often vague or appear to contradict federal regulations. There are even times when the terms are never defined in the state legislative language, leaving the lender wondering how to translate the term to even know where to begin to comply.

Compliance with these ever-changing laws, rules and requirements is quite challenging, and a stumble or two could cause great pains in having to address the repurchase issue.

"The question becomes what is 'ability to repay?,'" Ochoa says. "Is it a common-sense test? Will there be a mathematical formula to follow that is consistent between all laws and regulations? In a perfect world it would be defined with a universal no-nonsense definition with which all lending institutions could comprehend and comply," she says.

Third-party compliance systems emerging as investor requirement

I believe the future of mortgage lending will require independently provided compliance warranties or certificates from originators to sell a loan, just as flood certificates or MERS® registrations are required now.

"Seller reps and warrants are open to counterparty risk and, if enforced, erode business relationships," says Louis Pizante, chief executive officer of Irvine, California–based Mavent Inc.

"Certification, on the other hand, focuses on loan quality and actually improves seller relationships. Some investors are requiring or providing incentives—such as modified reps and warrants—for compliance-certified loans. Sellers are reacting favorably to this, as it eliminates repurchase risk and locks in gains on sale," he says.

How can lenders comply with these myriad regulations—federal and state—without losing their sanity? A combination of automation and good-faith efforts provides the easiest path to staying compliant and reducing the risk of buybacks.

"For regulations such as disclosure rules, lenders must make automation part of their system on every approved loan," Platt says. "If a loan cannot be underwritten until the proper compliance fields have been satisfied, lenders eliminate the chance of an overlooked disclosure or document damaging the loan."

Compliance software is not new, but it is gaining more attention as staffs shrink and investors analyze even loans in good standing for warranty violations.

Regulations such as HMDA, preliminary disclosures and fee calculations can be automated by software that is either purchased separately or integrated into loan origination software. These applications often contain features that flag incomplete applications, allow for batch editing or keep a loan from closing if all the steps have not been followed.

For laws with more subjective requirements, lenders can combine their best good-faith efforts with sound documentation and guidance tools. Lenders that use available tools to analyze income and document the decisions made and why will be in a stronger position to defend their portfolio.

As regulations become more complex and require lenders to provide more analytical support to loans before underwriting, software is available that assists lenders in making accurate decisions. Loan-analysis software can review tax returns and provide guidance on the suitability of a loan to the borrower.

TILA reviews, CRA tests and high-priced-loan checks can also flag suspect applications or provide the underwriter with the information needed to make an informed, accurate decision on the loan's status. Multi-state lenders can even use software that incorporates state and investor guidelines into the checks, ensuring compliance at all levels of oversight.

Compliance software is not new, but it is gaining more attention as staffs shrink and investors analyze even loans in good standing for warranty violations. Compliance is often classified as "overhead," implying that it strictly costs the company money. With all the challenges and costs associated with buybacks—not to mention fines or reputational risk resulting from violating laws—compliance also has become a way to reduce financial loss.

Technology that can test for various laws and regulatory requirements, combined with a well-educated compliance staff, is worth the relatively low cost compared with the millions of dollars buybacks can consume or the abrupt closing of a lending operation.

Pay attention to compliance. Use it to protect your company from costly mistakes. As the old proverb says, an ounce of prevention is worth a pound of cure. **MB**

Leonard Ryan is president of Laguna Hills, California–based QuestSoft Corporation, a provider of automated compliance solutions and geocoding services to the mortgage industry. He can be reached at leonard.ryan@questsoft.com.