SECONDARY MARKETING EXECUTIVE®

Reprinted with permission from the July 2007 issue

Hope Is NOT A Hedging Strategy

The secondary market's way of dealing with compliance is obsolete and full of risk.

By Lou Pizante and Paul Nidenberg

For an industry that prides itself on how smartly it takes risks, the secondary market's way of dealing with loan compliance is strikingly silly. It involves sampling loans post-closing, and generally post-purchase, and relies on the seller's rep and warrant that the loans comply with all applicable laws.

There are two obvious criticisms of this approach. The first is that post-funding, post-purchase is a bit late in the process to be considering compliance. Certainly the magnitude of compliance risk and the broad availability of efficient tools for managing it make easy the funding of compliant loans eligible for secondary sales.

Second, reliance on reps and warrants was fine when low rates and rising home prices made mortgage lending somewhat easy. But when times are bad, as the past few months have shown, reps and warrants look more like a nuclear option than smart risk management.

All of this is rather curious considering how successfully the mortgage industry has managed various risks. Historically, these risks have included credit risk, collateral risk and interest-rate risk. Mortgage institutions must willingly and optimally bear these risks to realize higher returns.

Significantly, the mortgage industry has resourcefully applied technology to efficiently and precisely manage risk (including automated underwriting, credit scoring, and sophisticated pricing and hedging econometric models). Secondary market investors have distributed these technologies to their sellers to facilitate more efficient secondary executions.

Accordingly, seller reps and warrants regarding these risks are increasingly narrowing to reflect these efficiencies. Given all this, one wonders why, when it comes to compliance, investors and rating agencies still rely chiefly on reps and warrants.

Reps and warrants

The answer has its origin in the development of the mortgage securities market. In the late seventies and early eighties, mortgage lenders routinely used recourse swaps with GSEs to create and sell securities. Then, existing regulatory and accounting rules allowed lenders to treat these transactions as a sale, even though the purchaser had recourse to the seller for credit losses.

Investors preferred to rely on the seller's balance sheet than on the quality of the underlying loans. Sellers, already on the hook for credit losses, favored reps and warrants over the costs of due diligence for other risks.

Consequently, the reps and warrants were drafted in the broadest possible terms, including a seller rep that the loan was compliant with all applicable laws.

In 1989, the Federal Institutions Reform, Recovery and Enforcement Act (FIRREA) forced a change in how the industry accounted for secondary market transactions by requiring that all recourse obligations be treated as "on balance sheet" financing transactions, not as sales. The industry responded by taking advantage of the recently passed real estate mortgage investment conduit (REMIC) legislation, which enabled it to replace recourse swaps by issu-

Lou Pizante is chief executive officer and Paul Nidenberg is chief financial officer of Irvine, Calif.-based Mavent Inc. They can be reached at louis.pizante@mavent.com and paul.nidenberg@mavent.com.

ing transactions using senior sub structures. Because these transactions were nonrecourse, investors shifted their focus from the creditworthiness of the seller to the quality of the underlying loans.

This sequence had at least two important consequences. First, the industry was motivated to develop sophisticated technologies and tools to assess loan quality, particularly borrowers' creditworthiness and property valuations. Specifically, automated underwriting (AU), FICO scoring and automated valuation models (AVMs) grew in popularity. Second, because transactions were no longer recourse, and given the spread of these cost-efficient risk management tools, sellers required that investors narrow the broad reps and warrants.

Not surprisingly, the vestigial rep and warrant regarding broad compliance with all applicable laws was not narrowed. Compliance was considered relatively benign at the time. The Home Ownership and Equity Protection Act (HOEPA) was not yet enacted, nor were there any high cost laws. Adjustable-rate mortgage products were only starting to grow in diversity, making Truth In Lending only an emerging issue in secondary market transactions.

Furthermore, the legal costs associated with diligencing loans made diligence cost-prohibitive.

So, while automated tools were replacing broad reps and warrants by more accurately and economically assessing loan quality, perceived risks and costs made it more sensible to carry over the broad compliance rep and warrant.

The times they are a-changed

This arrangement was fine for a time, but the industry started running into problems as the current decade opened.

On the one hand, the dot-com era produced meaningful gains in productivity and automated decision-making. On the other hand, the bursting of the dot-com bubble contributed to suspicions of corporate malfeasance. Among the results were a more complex regulatory landscape - but also, coincidentally, more advanced automated tools with which to navigate it.

Broader regulatory scrutiny meant, for the mortgage industry, an explosion in new regulations relating to predatory lending, licensing, state usury and (most ominously) suitability. In 1999, North Carolina was the first state to pass a high cost law. Over the next few years, 30 jurisdictions passed anti-predatory lending laws (nine states have laws pending).

But the industry experienced a boom, too. The Fed cut rates when the tech bubble burst, arguably creating another in housing. Volumes and housing prices grew dramatically. Importantly, the introduction of automated compliance engines (ACEs) made it possible for lenders to meet the growth in both market and regulatory demands, even if such tools were not always wisely and consistently adopted.

By 2004, as rates moderated and housing softened, significant overcapacity in the mortgage originations market resulted in looser underwriting and the rise of nontraditional mortgages. Pressure on margins compelled many originating lenders to cut costs. For some, compliance risk came to be viewed as a high-magnitude, low-probability risk. This is not surprising considering investors' continued comfort in limited sampling and ultimate reliance on the broad compliance rep and warrant. Reliance on ACEs has naturally led to a compliance gap, as investments in many ACEs have not kept apace with new product development.

All this matters now. Compliance issues are rarely uncovered on performing loans. It is only when borrowers default that attention is paid to whether loans are compliant.

And the data bode ill. RealtyTrac estimates some 1.3 million homes were in default on their mortgages in 2006, up 42% from the year before. According to First American CoreLogic, 18% of all people who took mortgages out in 2006 now have negative equity, and a quarter of all mortgages due to reset in 2008 are in the same grim shape.

With estimates of one subprime borrower in eight behind on payments and seller casualties mounting, it's getting gloomy for investors that relied too heavily on reps and warrants.

Too much strain

The impact of anti-predatory laws and other compliance issues is well documented. Investors can be liable for fines and penalties that exceed a loan's value. The rating agencies continue to exclude from rated pools certain loans secured by homes in some states, including New Jersey and Massachusetts. Some ordinances bar investors from doing business with the county, including municipal bond underwriting and pension asset management.

But compliance risk also takes a serious toll on the relationship between an investor and seller. While "back end" compliance reviews identify non-compliant loans, they do so after the loans have already been funded. This situation places the investor in the awkward position of deciding whether or not to demand that the seller repurchase the noncompliant loans.

On one hand, the investor can choose to keep the loan and, as assignee, take responsibility for curing it (or be held liable if the loan is later found by regulators, the borrower or the borrower's counsel to be noncompliant). On the other hand, the investor can fall back on the rep and warrant, forcing repurchase by the seller. The latter is done at an extreme cost to the originator.

It is the hoariest dilemma in business ethics: investors are given the choice between holding an asset that defrauds the homeowner or souring client relationships. It is, however, a decision investors can avoid having to make.

ACEs high

A solution is for investors to maintain ACEs, make them available to sellers, and provide rep and warrant relief for loans that are deemed eligible by the ACE. Not only does this make good business sense, but it represents the ultimate

high road in responsible lending.

If investors made such an ACE available to sellers (similar to how investors use AU), sellers would be better able to fund compliant, eligible assets in the first instance. This would result in better economics by providing all parties greater certainty of execution and improved counterparty relationships. It would also reduce back-end diligence costs.

The need for the secondary market to embrace ACEs the way it does AU and AVMs is obvious, but neglected. There are two arguments investors raise.

The first is that investors do not want to represent to sellers that they are assuring that a loan indeed complies with applicable law. But this misses the mark wide.

The purpose of an ACE is merely to ascertain whether a loan complies with certain investor guidelines and, based on other factors, is eligible for purchase. It no more ensures against seller compliance exposure than does AU protect the seller from defaults.

The second argument is that investors do not have all the data required for automated compliance reviews. ACEs require access to different data than that commonly provided in secondary transactions. Often, investors are reluctant to request these data, citing competitive pressures. Additional data create additional cost for the seller.

But the pressure to narrow other reps and warrants and the current market turmoil make it obvious that, once available, technology is always a more attractive alternative to broad reps and warrants. Quality ACEs are a much better hedge than making promises and crossing fingers.

Why it pays to comply

In large measure, the secondary market has failed to recognize that compliance is about managing risks, not just costs. The difference between risk management and cost management is an important one. Credit, collateral and interest rate risk management strategies yield rich rewards for some institutions and wreck others.

The same is true for compliance. Depending on its charter or license, a lender often has permissible options that enable it to originate assets with better cashflow characteristics and greater risk-adjusted returns.

But surprisingly, the secondary market rarely considers this. Instead, investors apply a "lowest common denominator" compliance analysis that applies the most restrictive set of laws to all loans and, consequently, leaves money on the table.

Sophisticated ACEs can tailor reviews to consider the sellers' regulatory options and investor-specific policies. This results in a more precise pricing of risk that an investor can use to bid more aggressively and profitably - which, to sum up, is consistent with the industry's long-standing view of risk management as a source of competitive advantage. SME