nationwidetitleclearing.com

White Paper:

Assessing Collateral Risk in the Age of Digital Lending

By: Amie McCarthy &

Meaghan Hunter-Hanley

Vice President of Business Development – Capital Markets, Nationwide Title Clearing, Inc

As seen in [Mortgage Bankers Magazine] written by Amie McCarthy and Meaghan Hunter-Hanley

In this historically low rate environment, mortgage bankers will end 2019 on a high. The 30 year fixed mortgage rate fell to a 3-month low in January 2020, falling five basis points to 3.81%,[i] fueling purchases and refinances.

The U.S. unemployment rate dropped to 3.5% in November, a 50 year low.[ii] The National Association of Home Builders housing market index saw builder confidence rise in July of last year, rising to 65 points,[iii] reflective of a “cautiously” optimistic in the face of solid demand for single-family homes.

Existing housing supply remains tight and lower priced homes are scarce, leading Redfin to predict that 1 in 4 offers in 2020 will face a bidding war.[iv] Homeowners are aging in place longer than predicted,[v] but millennials are no longer delaying household formation.[vi] Digitally enabled, arm chair buyers are empowered to shop and finance their homes online.

The digital mortgage revolution is here with app based applications, e-mortgages, digital closings and notarizations becoming more prevalent. This shift is advantageous to the consumer and lender. Accurate and rapid closings are in everyone’s best interest, saving time and money. Mortgage bankers are competing for the same borrowers, and focusing on the customer experience.

With banks shying away from government lending programs,[vii] and non-banks embracing Ginnie Mae mortgage backed securities issuance, the stakes are high from a collateral perspective.

New players have emerged in the market, who may not know the rules. Non-qualified mortgages are more common as government insured programs and conventional loans do not suit every borrower. Ginnie Mae MBS issuance reached $56.09 billion in November,[viii] while Fannie Mae and Freddie Mac issuance totaled $117.6 billion for single family MBS in the same month. Private label mortgage backed securities[ix] are having its biggest year since 2007, forecasted at $40 billion for 2019. With volume comes collateral risk.

Are you aware of the collateral requirements to retain, service, sell or securitize loans? Are you able to recertify Ginnie Mae pools? Are you getting the necessary trailing documents from lenders, title companies, attorneys and closing agents to complete your collateral files?

Whether you are an originator, correspondent, purchaser or issuer, collateral management is crucial to successful transactions. Preparation, execution and recordation of accurate instruments is imperative.

With the increase in production and changes in regulations and requirements, these issues are becoming even more important. In this White Paper, we will explore collateral risk across five areas, all through the lens of increased digital lending so you can answer the question: Do you know your collateral risk?

Counterparty Risk

Are you working with lenders who can deliver clean collateral files?

Lenders are optimizing the borrower experience, but are they using that intelligence for the sale and transfer of portfolios?

Larger lenders can invest in technology or engage with business processing outsourcing firms to optimize processes. Smaller players tend to retain post-closing functions, perform them manually, and may leave issues unresolved due to time and expense to cure.

Once a loan is sold, and representation and warranties have expired, lenders may not address outstanding items. With much of the focus on origination processes, post-closing and documentation do not always get the attention it requires and deserves.

Can you count on your partners to manage your collateral risk?

Are your partners sending documents in an efficient manner? Are they actively managing the custodian and closing agents to ensure you get trailing documents? Do you have to ingest paper files, “data dumps”, poor quality images, and “blobs” of unindexed documents? Will they provide a duplicate, indexed file to assist with loan boarding and conversion?

Once you know what you have, what is missing or incorrect, is your partner willing and able to cure deficiencies? Having a process to detect, track, manage and resolve outstanding collateral issues is essential to maximizing best execution.

As the saying goes, you are the company you keep. Ensuring your lender partners are committed to on time delivery, promptly addressing exceptions and curing issues, is crucial to successful transactions. In the event sellers are unable to mitigate collateral issues, the ability to put back loans should be built into loan purchase agreements.

Financial Risk

Are you acquiring whole loans at a price that makes sense given your risk?

Whole loan buyers are reducing due diligence whether it be for time or financial reasons, or both. The less known about the pool, the higher the risk.
Buying closed-end seconds blind? Purchasing distressed first mortgages? Reverse mortgages? You need to know the collateral to make an informed decision, and not overpay.

Some document and vesting issues can be repaired, if you know they exist. How do you calculate price and reserves on an asset on which you cannot define your collateral risk? What if the originator is unable to repurchase a loan? Do you have a comprehensive purchase agreement which requires put back for collateral imperfections that remain uncured?

When originating and managing post-closing, you have more control than purchasing from others. Acquiring loans increases your risk. Having a process or partners to review collateral is essential.

Few collateral issues are insurmountable, but you need to know the cost to cure to properly bid and price up front. Although you may identify issues in pre due diligence, knowing the cost to rectify post-acquisition can ensure you may still obtain target return on investment for the asset. Depending on the asset management strategy, firms may be willing to accept compromised collateral.

However if the intent is to give cash for keys, take a deed in lieu, short sell, or foreclose, imperfect collateral is an impediment. Even if you purchase at a discount, you may overpay if you cannot make an asset cash flow, or have disposition at the target rate of return.

The longer exceptions linger, the less likely they will be resolved. Although some firms retain assets on balance sheet, others who finance on warehouse lines may not be able to service and retain whole loans for an extended period of time. Aged exceptions cost time and money for the originator and purchaser. The cost to carry imperfect collateral is high.

Having a process to track, manage and resolve collateral issues is a crucial component to managing financial risk.

Documentation Risk

What happens if you have imperfect collateral files? (and do you have recourse?)

Without a chain of title, evidence of legal transfers of the ownership of a mortgage, and other collateral documents, banks and servicers may not have the ability to collect the debt. Once you have an asset with an impaired chain of title and ownership it may be difficult to sell, if not cured.

All assignments must be prepared and recorded following a transfer or sale, and a failure to do so can irreparably rupture a chain of title. The National Mortgage Settlement of 2012 made it clear this cannot be taken lightly.

How can you ensure a purchased loan has the chain of title and ownership intact? Have you placed terms in your purchase contract in the event exceptions are not cleared by the seller?

Whether new origination, seasoned, non performing or re-performing, compromised collateral and documents impact the ability to service, sell and securitize. Even if a transaction closes smoothly, with all required documents, the process slows down when documents are sent in paper form to counties for recordation.

The mortgage process is not entirely digital and paper recording still occurs the majority of the time. Knowing all required documents exist, are executed and recorded, is a challenge. Having recourse in a purchase contract is highly recommended.

A process to monitor and remediate exceptions is also advisable, or partnering with a firm that can do so on your behalf.

Documentation risk can be mitigated with collateral due diligence. In purchase transactions with little or no recourse, due diligence is imperative. Having knowledge of the investor and product characteristics and how the portfolio was originated is essential. Pre-sale due diligence is all but expected in non-performing and re-performing whole loan sales.

As a purchaser, what can you do to mitigate collateral risk? Have a process to identify collateral issues and a mitigation plan to rectify exceptions. Whether it is a representation and warranty to demand repurchase, or having an internal process or external partner to remediate collateral issues, its best to be prepared.

The most unlikely exceptions are usually the most costly. Post purchase exceptions may be identified which were not disclosed in the diligence process. This may occur due to the seller not understanding the requirements to satisfy a specific exception or stipulation.

It is common when pre-sale collateral due diligence is only performed on a percentage of the transaction to find issues. When assets go to market based on custodial inventory reporting and are not reviewed pre bid, exceptions are discovered after the transaction is closed. Now what?

Missing documents and imperfect collateral is not an insurmountable situation. Along with the original collateral file at the custodian, it is strongly suggested to create a copy of the collateral file, and any servicing files to ensure continuity. Perhaps some documents are still in the process of being recorded, and an unrecorded copy exists.
Each county has their own process and pace. Missing or unrecorded assignments, mortgages, deeds of trusts and title policies are not deal killers. Take stock in the known, determine what is easily remedied and does not impair the loan value, and identify the complex collateral exceptions.

Depending on the time and expense, you may be able rectify the issue in house, if your post-closing area is skilled. Or engage a third party that specializes in rectifying collateral issues, at a lower cost and higher rate of success than you can on your own.

Legal Risk

How can you prove you own a loan?

When purchasing assets or servicing rights, banks and servicers have obligations to notify borrowers in the event of any assignment, sale or transfer of a mortgage loan per Consumer Financial Protection Bureau (CFPB) Regulation X, 12 CFR Part 1024. Consumers have further protection if their mortgage is transferred and in default, under the Fair Debt Collections Practices Act (FDCPA). A mortgage lender must be able to prove the ability to collect a debt, which is demonstrated by a proper chain of title, contained in the mortgage collateral file.

Having a complete collateral file, with original recorded assignments, mortgage, and/or deeds of trust, title policy, any security instrument, chattel mortgage or equivalent, and evidence of mortgage insurance (MIC, LGC, evidence of FHA mortgage insurance, VA or RHS guaranty), or copies thereof if acceptable, is evidence of what a lender has purchased, and supports the ability to collect a debt.

Incomplete collateral files which do not properly reflect the chronology of events by which a new loan holder acquired ownership may hamper the ability to start legal proceedings in the event of default. It is advisable to maintain a duplicate of the collateral file, in the event a copy of a legal instrument is needed to verify loan terms, or ownership of the debt. The last thing any lender needs is to miss a filing date because they could not obtain a copy of a mortgage and note.

During the credit crisis, many servicers were impaired by incomplete or missing collateral. Many firms could not prove an unbroken chain of ownership due to missing, blank or unrecorded requisite assignments following the mortgage origination and sale into a mortgage backed security. Without the proper assignment of mortgage, endorsement of the Note, and all intervening assignments into a Trust, a lender or servicer cannot prove their right to collect a debt.

Purchasing loans with an imperfect chain of ownership can lead to legal issues, if you are unaware of vesting, and an inability to foreclose in the event of non-payment. Depending on your investment and asset management strategy, defective collateral is buyer beware.

Operational Risk

How can you ensure your transaction management from origination to sale is operationally effective?

With change, operational risk increases.

With all the revisions to mortgage origination process, such as the change from the HUD-1 to TILA/RESPA Integrated Disclosures, how do you know the lender from whom you are purchasing has it right? How do you know your collateral is correct?

What will happen when the Universal Residential Loan Application (URLA), effective date arrives February 1, 2020? Do you have protocols to monitor and manage operational risk? Do you have change management processes for implementation of new regulatory and investor requirements at your software vendors?

Supervised lenders likely have this in place, but smaller originators may not have the necessary controls to detect and prevent errors. Operational breakdowns often occur following change.

In the new digital mortgage age, operational risk has become more complex and linked to technology and third party vendor risk, as the mortgage process has become more automated. With lenders dependent on software vendors for underwriting and processing, preparation of disclosures, closing packages and borrower notices, operational risk has increased.

As standards and regulations change, change management and operational risk monitoring is more important than ever. Lenders have more responsibility to manage change and monitor third parties that assist them in facilitating transitions.

The mortgage industry has absorbed and implemented many changes since Dodd Frank. Working with third parties to implement change can increase speed to market, as lender may not have capability to develop technology.

With the introduction of additional software and processes comes operational risk. Third party oversight, risk assessments and compliance reviews are necessary to routinely and proactively monitor for operational risk, both internally and at vendors.

In the digital mortgage age, mortgage transactions are becoming easier, and more efficient. With fintechs actively offering a fully digital consumer lending experience, the mortgage industry is looking to follow suit. E-mortgages are becoming more prevalent. Digital closings and notarization is becoming more common. Ginnie Mae and the GSE's are looking to modernize the mortgage industry's future with E-mortgages and E-vaults.

With all this innovation making the process more efficient, it does not reduce collateral risk.

Paper or electronic, collateral risk will remain and become more complex with new technological and privacy concerns. Whether internally managed or outsourced to a trusted partner, collateral risk can be mitigated. Investing in due diligence and collateral risk management services is money well spent.

To find out more about how Nationwide Title Clearing works with lenders, servicers, investors and other industry participants manage these risks, contact us today.

###

i Campisi, N. (2020). *Mortgage Rates Fall To 3-Month Lows | Bankrate*. *Bankrate*. https://www.bankrate.com/mortgages/analysis/

ii Soergel,Andrew (2019) November Job Growth Booms as Employers Add 266K Positions | U.S. News https://www.usnews.com/news/economy/articles/2019-12-06/november-job-growth-booms-as-employers-add-266k-positions

iii Bondarenko, V. (2020). *Builder confidence rises in July*. *Inman*. https://www.inman.com/2019/07/16/builder-confidence-rises-in-july/

iv Orton, Kathy. (2020). Experts predict what the 2020 housing market will bring | The Washington Post https://www.washingtonpost.com/business/2020/01/06/experts-predict-what-housing-market-will-bring/

v Lerner, Michele (2019). More seniors “aging in place” mean fewer homes on the market to buy | The Washington Post https://www.washingtonpost.com/business/2019/04/09/more-seniors-aging-place-mean-fewer-homes-market-buy/

vi Sharf, Samantha (2019). *Yes, Millennials Really Are Buying Homes. Here’s How*. *Forbes.com*. https://www.forbes.com/sites/samanthasharf/2019/07/08/yes-millennials-really-are-buying-homes-heres-how/#20c0803a4504

vii Eisen, B. (2020). *Banks Fled the FHA Loan Program. The Government Wants Them Back* . *WSJ*. https://www.wsj.com/articles/banks-fled-the-fha-loan-program-the-government-wants-them-back-11557417600

viii Ginnie Mae *Press Releases* . (2020). *Ginniemae.gov*. https://www.ginniemae.gov/newsroom/Pages/PressReleaseDispPage.aspx?ParamID=186 ix *Opinion: Behind the bond boom no one saw coming in 2019*. (2020). *Asset Securitization Report*. Retrieved 14 January 2020, from https://asreport.americanbanker.com/articles/opinion-behind-the-bond-boom-no-one-saw-coming-in-2019?tag=0000015d-66a2-d8f3-ad7f-77b6a3430001