White Paper:

MITIGATING THE RISK THAT HIDES IN CLOSED LOAN FILES

By Michael O'Connell

Due diligence has taken on an entirely different shape in the post financial crisis world. Increasingly, regulators, investors and banking executives are looking deeper into the individual loan files whenever a pool of loans sells, is acquired through merger or is securitized. The industry has come to the realization that if we hope to be successful with a portfolio we purchase, make the most of a new entity we acquire or make the best use of the capital markets to fuel our businesses, we must mitigate all of the risks that are working within that portfolio. These risks are higher for seasoned loans, which are subject to many problems that will be detailed in this paper.

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Fannie Mae and Freddie Mac have consolidated their securitization infrastructure, which could mean more opportunity for tapping the capital markets for liquidity. The ratings agencies are already responding to pressure from investors for more information about the loans that back MBS. We have been pleased to see the major rating agencies upgrading their systems to better gauge this risk. Most recently, two of the largest of these firms announced changes to the way they would be evaluating the collateral files of the mortgages that back securitized pools.

Fitch Ratings and Moody's Investors Service, both in New York, each announced updates recently that will impact their prime RMBS ratings criteria for seasoned loans. This is so important because even with the new safeguards put in place by originators post-crash, the loans that are already in portfolio are still subject to the risks from problems hiding in the collateral file.

The companies told news outlets that they took the action as a step toward assessing several risk factors "including contractual representations and warranties." In addition, one of the firms, Moody's, includes a risk assessment of deals based on both reps and warrants and a review of the data quality by an independent third party. Fitch said it was basing its assessments on additional criteria related to seasoned, performing loans, including the strength of reps and warrants, according to published reports.

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This is a step in the right direction. In the past, the ratings agencies did not make this kind of assessment when rating mortgage backed securities, certainly not specifically related to the collateral file. This should allow the agencies to uncover risk hiding in the file, such as missing key documents or assignments to another entity that were not indexed into their servicing system. This will go a long way toward protecting investors from investing in securities where problems with the underlying assets erode the value of the security over time.

Unfortunately, the truth is that the problems hiding in many of these files pose serious risks to the industry long before the loans are ever evaluated by the ratings agency. It's going to be up to the industry to catch these problems before they get far. Failing to do so will attract negative attention from the industry's chief regulator.

The Consumer Financial Protection Bureau has correctly identified the servicing transfer, post default servicing, as a source of potential risk, as there are many errors that can make their way into the collateral file during this process. Earlier this year, the agency put new rules in place that require processors to maintain accurate records, promptly credit payments, and correct errors on request. The hope is that these rules will allow servicers to mitigate the risk that documents and key financial information are not accurately transferred.

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In our experience, there are a number of problems that are currently impacting a significant subset of all seasoned loans currently held in portfolio by the nation's servicer's business – and any other company doing business with that servicer.

The Threats the Industry Faces and the High Cost of Failure

Far and away, the most significant threat most industry players will face due to problems in the loan file is buyback.

Between 2011 and 2013, the former GSEs, Fannie Mae and Freddie Mac, issued buyback requests for over $81 billion in loans. The settlements that have come from these requests have slowed the overall growth of the industry and kept other investors from re-entering the market. This is one of the most powerful forces driving change and a new level of due diligence.

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While this may sound like a loan origination issue, we have found that document handling from Post Closing in the mortgage loan servicing business is just as important – or even more important – because handling this function poorly will allow risk to hide in the collateral file when loans are later released or securitized or when servicing is transferred.

Another threat is a secondary market that remains sluggish due to the reluctance of new or institutional investors to re-enter the market. These investors have been satisfied to sit on the sidelines and observe the efforts of the government agencies as they work to remove risk from the system and perfect a lending process that will not lead us to a repeat of the historic downturn.

Without these investors to fuel future growth, future mortgage demand may not be met. To win them back, we must replace the memory of their experience during the crisis with the security that comes from an enhanced level of due diligence.

We should also remember that for those lenders that sell whole loans as a way to fuel additional business, having to wait for payment until loan files are perfected is nearly as bad as a buyback request. Their businesses are just as effectively stalled.

Finally, we cannot ignore the risk of punitive action, either by the courts in the case of a judicial foreclosure or by the industry's regulators. In either case, the costs – as have been made quite clear in recent news reports – can be extraordinarily high.

Uncovering the Hidden Risks

So, where then are these risks hiding in the loan portfolio? In our experience, there are many problems hiding in the loan collateral file that, if not uncovered, will cause significant problems at some point in the future.

The risk factor that results in the most errors in the file after the processor releases the loan file comes from preparing documents based on unverified or insufficient data. More errors occur here than anywhere else in the process. When they occur, they create rep and warrant risks. Specifically, there are a number of risks that we have identified that spring directly from these errors:

- No mortgage or multiple mortgages
- Missing assignments or Lost Note Affidavits (LAAs)
- Missing modification or multiple drafts of modifications
- Missing title policy requiring retrieval or replacement
- Flawed documents in the chain of assignments

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Many seasoned loans were originated before the financial crash or before the borrower experienced economic difficulties. Many of these loans entered the default servicing process and were assigned to special servicers or attorneys for processing. Some of these borrowers were able to cure their default and the loan re-entered the system, but was never properly assigned back to the original servicer. If such a loan were later sold, a break in the chain of title would post a serious complication.

We have also seen custodial handling exceptions that cause problems when the loans are ready to transfer. While these trailing docs are routinely collected, audited, and stored securely by the document custodians, it's reviewed only on a sample basis with limited data sets. Rather it is monitored by the individual servicer. Typically, problems here are not identified until the loans are ready to transfer.

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Finally, there are many problems that come out of multi-branch operations because these organizations can be very difficult to monitor unless the company has set up a method for centralized review of the loan files.

These are errors that can cause problems when the loan is put up for sale or is bundled into a pool for securitization. In fact, some of our clients have found, after a close inspection of the loans in the pool, that up to 90% of the loans have errors in the file that would prevent them from passing the Quality Assurance department. These are loans that will get the attention of the ratings agencies in the future. They are also the files that will attract negative attention from federal regulators.

The industry must adopt an approach that will reduce or eliminate these errors. Fortunately, there is an approach that will do exactly that.

Successful Risk Mitigation for Loan Sales or Securitization

When it comes to errors in the loan's collateral file, the best approach to mitigation comes from a culture of prevention.

Prevention involves conducting a collateral documentation review and mortgage/assignment chain audit as part of the servicer's document preparation process. This is typically a two-part process that involves a research phase and an internal process for document review.

In the research phase, the servicer searches the public record to ensure that there are no breaks in the assignment chain that could compromise future assignments or a lender's lien position, right to foreclose, validity of documents, etc.

Before preparing the document for a new assignment, the servicer must determine whether or not the current loan beneficiary is clear on a property by reviewing land records to examine the entire chain. It is likely that servicers will require the aid of expert researchers during this phase, as they have the skills to properly conduct a thorough review of land records to examine all documents that are of public record on the property, from the mortgage forward, to determine if the assignment chain is complete.

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The second part of prevention has to do with the establishment of internal processes for document review, and signing that allows the servicer to effectively manage and control all authorized signers with a very high level of accountability. Protocols should be established for signer authentication and all employees must follow them before any document is printed and executed. It is also important that every document be scrutinized for accuracy, executed properly and the process documented so that if the integrity of any document is called into question, servicers can support their process.

We have found that a signing authority database will allow servicers to be certain that documents are only signed by someone with the proper authority. By linking each individual signer's name to the authorizing signing authority document in the database, and preventing any document from being signed unless and until that link is validated, servicers can be certain that document is signed correctly.

It is important that the servicer's signing executives are also trained to inspect every document they execute to ensure the forms are complete and compliant. Any supporting source documentation as well as any company research should be provided to verify accuracy.

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An eRecording system that allows authorized signers to electronically affix their signature to documents that are submitted electronically to a County Recorder's office is a great addition to any servicing enterprise. Current systems are very efficient and observe all Notary laws and signing best practices.

In cases where the problem already exists and the servicer is fortunate enough to have uncovered it before the loan is transferred or pooled for securitization, curative action must be taken. There are many ways things can be done incorrectly, but generally only one way to do them correctly. When corrective actions must be taken, they may be more complex than doing the job right the first time. In many cases, the services of a professional will be required.

Finding the Problems to Mitigate the Risks

While prevention is the recommended approach for mitigating these risks in the future, the reality is that millions of loans are already in portfolio with problems hiding in their files, many of them very serious. The only solution that can be applied to these problems involves a more aggressive approach to due diligence before loans are sold or pooled for securitization.

This will require the industry to abandon the assumption that just because the origination file met the standards set forth by the investor and the regulator that the servicing file will also meet the same standards. Because most of the problems we have discussed above are introduced into the file post-close, we can never make this assumption.

In our experience, making this assumption has allowed some serious problems to remain hidden in the collateral file for years. We have seen:

- Loan amount discrepancies between the mortgage and the servicing database
- An incorrect property listed on the title policy
- A different borrower name on the title policy than on the loan documents
- Files that don't reflect the beneficial rights to service the loan

Even when the loan has closed and been approved by the investor, there are still significant issues that can occur with the origination files. We have seen files:

- Without a note
- With missing Allonges
- Without a loan application
- Without a title policy

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Instead of making an assumption that a closed and funded loan means a good loan file, the collateral file must be inspected as part of the due diligence process. In our experience, there are more than 40 critical inspection points within the file that should be inspected as part of a complete due diligence process.

When problems are identified, they can be cured, as described above. Finding problems too late reduces the chances that they can be cured before incurring significant expense. This process may involve locating, recreating or ordering new documents for the file. In fact, we consider it a best practice to perform your loan file due diligence even before a buyer has been identified for the loans you plan to sell. The days of waiting to perform due diligence until an agreement has already been made in principle are over. That is now too late.

To find out more about a due diligence process that can both uncover and cure problems in the collateral file in a timely and affordable manner, call Nationwide Title Clearing today.