

MBA's 97th ANNUAL CONVENTION & EXPO OCTOBER 24-27 ATLANTA

The Quality Revolution

Leveraging Technology to Restore Faith in Private Label Securitization



Morgan Stanley



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Overview and Current Challenges Originators Face

Lessons Learned and the New Face of Lending

The Secondary Market

Questions and Answers

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Overview and Current Challenges



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Which industry participants are best suited to shoulder the necessary level of risk to ensure products are originated in a responsible manner without limiting access to credit?

How do you separating yourself from investors through quality performance metrics?

- Innovative methods to track loan performance

Enable your business to consistently deliver quality products to the secondary market

- Ensure
 - Compliant origination practices
 - Quality Loans

Rebuilding the Private Label Securitization Market

What is true compliance?

- Authenticity of the documentation vs. “complete file”

“Check the Box” compliance exam is a thing of the past

- The cost of a culture of non-compliance

War stories

- 2005 “This can’t be legal”
- To shred, or not to shred?
- Is that White Out? No sir!

Why what the regulators do should matter to you

- Examinations are independent verification of portfolio quality
- Examiners are useful.....really

Technology

- The Saving Grace
- Validation of performance

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Lessons Learned and the New Face of Lending



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Dodd-Frank, TILA, etc.

- Risk retention
- No steering
- Repayment ability

Secondary market.

- What will they buy?

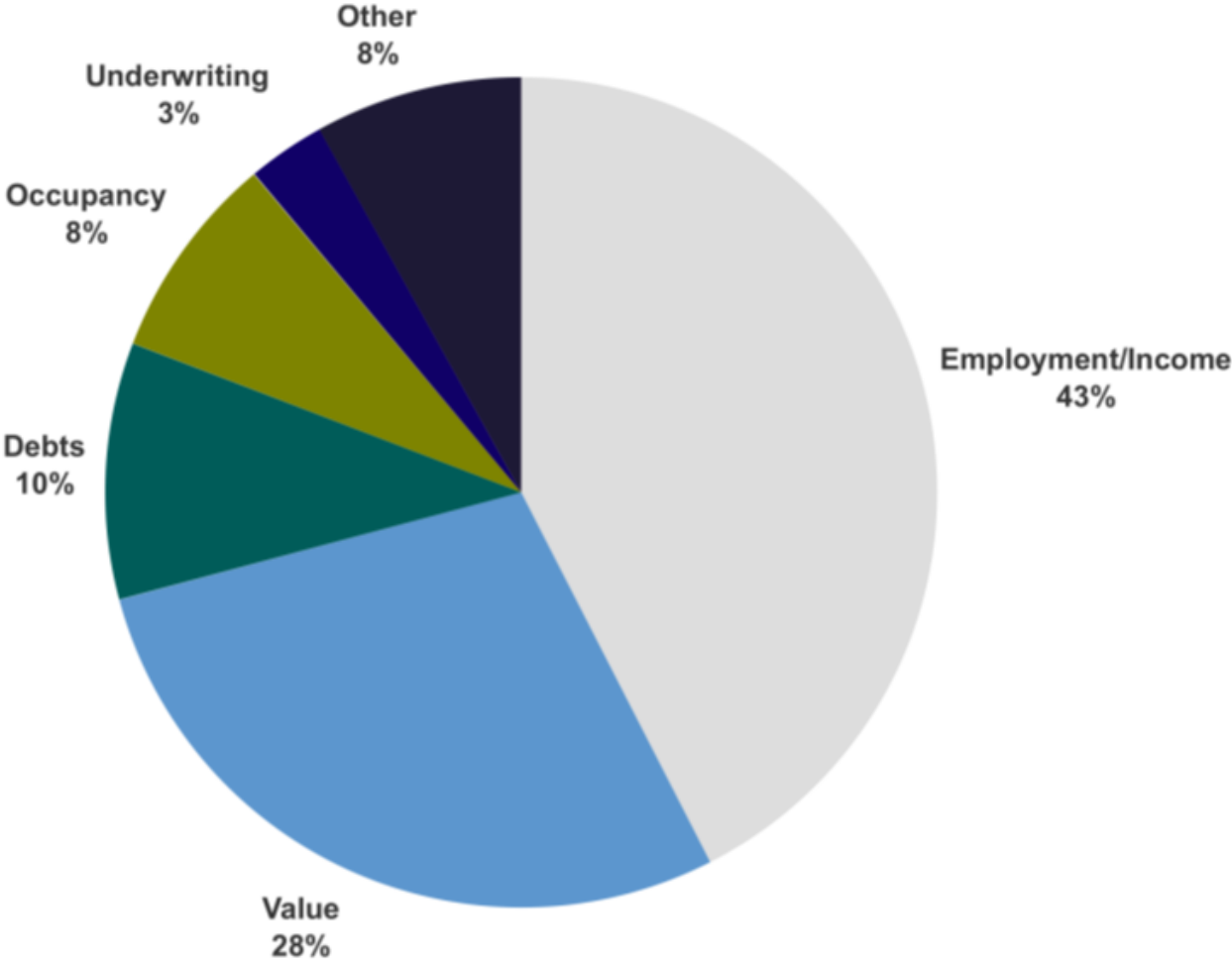
Regulators

- New rules – e.g., suitability
- What don't they like?

FHA; “Qualified Mortgage;” what else?

Lessons Learned / Being Learned

- Performance isn't enough
 - “But the borrower has never missed a payment.”
 - “But it was a stated income loan.”
- Quality Control / Quality Assurance
 - Tweaks necessary
- Role of due diligence firms
- Role of mortgage insurers
 - “The MI did what?”
- Investor standards
 - A breach is a breach.
- Regulator standards



Source: Repurchase reviews performed by CrossCheck Compliance

What Can Originators do?

- Demonstrated Compliance
- Demonstrated Performance
- Transparency
- Quality Control
- Technology
 - Front end
 - Back end

Originators Can't Do It Alone

- Consistency / Reasonableness / Logic
 - Originators
 - Investors
 - Mortgage Insurers
 - Rating Agencies
 - Due Diligence firms
- Technology
- Transparency, Transparency, Transparency

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The Secondary Market



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Recent trends within the mortgage industry have forced secondary market investors to place renewed emphasis on loan quality and regulatory compliance

While the collapse of the subprime mortgage market in July 2007, and surge in mortgage fraud forced secondary market investors to emphasize loan quality, a more intense focus on loan quality has arisen due to the following factors:

- The Tightening of Credit Guidelines by Fannie Mae, Freddie Mac and FHA
- Regulatory Reform
- Reputational Risk
- Heightened Enforcement Action and Repurchase Activity

These developments have caused secondary market lenders to redefine the focus of their internal quality initiatives and how they evaluate prospective and existing relationships with primary market originators and settlement service providers

- Renewed emphasis on prudent underwriting practices, focused primarily upon evaluating an applicants repayment ability and verifying core qualifying information through commercially recognized methods
- Placing primarily emphasis on strong corporate governance and expansive internal risk controls when evaluating primary market originators

Bottom Line - Primary market originators cannot build or sustain mutually beneficial relationships with secondary market investors without a strong commitment to loan quality

Tightened credit guidelines, heightened enforcement trends and regulatory reform have caused secondary market investors to consolidate their correspondent lending platforms

Primary market originators that do not possess strong compliance and quality control infrastructure within their organization will find it difficult to find a sustainable business partner within the secondary market

What are secondary market lenders looking for from primary market originators?

- Management which understands the need for balance between production and risk; as evidenced by management involvement in creating and enforcing compliance and quality control standards, publishing best practices, etc.
- Strong Financial Capacity – ability to meet rising minimum net worth standards
- Strong historical loan performance record and low reputational risk, (portfolio performance with GSEs and FHA, and standing with key regulatory bodies)
- Significant Quality Control Infrastructure – presence of strong quality control and compliance presence within the organization which is independent from business units, (sufficient staffing, experience, reporting lines, key involvement in policymaking of entity).
- Commitment to originating loans through prudent underwriting and origination practices.
- Written Policies and Procedures which identify acceptable origination and credit standards, and outline how those standards will be evaluated
- Internal Controls which require on-going internal and external evaluation of policy, procedure, personnel and loan performance
- The ability to track regulatory changes and adjust their origination and quality control controls accordingly
- Integration of quality control and compliance oversight throughout all stages of the origination process
- Anti-Fraud Controls
- Responsible Marketing Practices – Subject all marketing and advertising materials to prior approval standards
- Training and Continuing Education Programs
- Prudent Originator and Employee compensation plans which do not incentivize steering or aggressive credit decision-making
- Ongoing reviews of third party vendors, including third party quality control providers
- Strong Fair Lending Program

In today's mortgage environment, with its tightened credit guidelines and heightened levels of enforcement, investors are subjecting loans to significant scrutiny prior to their delivery into the secondary market.

To ensure the continued growth and sustainability of its secondary market investor base, primary market originators must ensure that each loan submitted for delivery satisfies applicable regulatory and credit guideline requirements.

How can primary lenders ensure the successful delivery of loans to the secondary market?

- Maintain written compliance and quality control policies and procedures which define your entities internal quality and credit standards
- Establish procedures and controls which ensure your quality control standards are being tested on each prospective loan, throughout various stages of your origination process
- Subject all prospective loans to a pre-closing quality control review to prevent mortgage loans with significant credit, compliance and quality defects such as misrepresentation, inaccurate data, or inadequate documentation
- Validate AU findings (DU/LP)
- Conduct monthly assessments of a percentage of your closed loan and default loan portfolio to assess credit quality
- Conduct monthly assessments of a percentage of your default loan portfolio to identify common default trends (including all first payment default and early payment default loans)
- Utilize mortgage specific anti-fraud programs, and develop an internal procedure to address identified discrepancies or fraud indicators
- Ensure that you have an effective way to communicate changes to policy and procedure to your origination, credit, compliance and quality control personnel
- Subject all employees to periodic training of key credit, compliance and quality control procedures

Aspects of Dodd-Frank that will likely effect secondary market activity

- *Ability to Repay Requirement* - Prohibits creditors from making residential mortgage loans unless creditor makes a “good faith” determination, based on verified and documented information that, at the time the loan was consummated, the consumer had reasonable ability to repay loan according to its terms, and all applicable taxes, insurance, and assessments.
 - The creditor’s reasonable and good faith determination of a consumer’s ability to repay the loan would have to include consideration of the following in connection with the consumer: credit history, current income, expected income the consumer is reasonably assured of receiving, current obligations, debt-to-income ratio, or the residual income the consumer will have after paying non-mortgage debt and mortgage-related obligations, Employment status, and other financial resources other than the consumer’s equity in the dwelling or real property that secures repayment of the loan.
 - Elimination of the reduced documentation loan product

Risk Retention - Generally prohibits securitizers and originators from hedging any retained risk directly or indirectly. Skin in the game requirement. Single-tranche securitizations of pools consisting solely of qualified residential mortgages will be exempt from the risk retention requirements.

- How will SRP structure be altered by the risk retention requirements?

Originator Compensation – Seeks to prevent steering by prohibiting lenders and brokers from giving or receiving compensation that varies based on the terms of the loan (other than the amount of the principal).

Enhanced Assignee Liability

- Assignee liability under TILA if loan does not satisfy the requirements contained within Section XIV – Mortgage Reform Act (ability to repay, originator compensation, etc.)
- Borrowers may assert a defense to foreclosure in either a judicial or non-judicial action – brought by the creditor or its assignees if the creditor violated the anti-steering and ability to repay provisions

Qualified Mortgage Safe Harbor - The Mortgage Reform Act would provide that a creditor under a residential mortgage loan, and any assignee of the loan subject to liability under TILA, may presume that the loan has met these new ability to repay requirements if the loan is a qualified mortgage.

- Will there be a market for mortgage that do not meet the definition of a qualified mortgage?
- Will lenders originate non-qualified mortgage and place them in large pools, in the hopes that a market will develop?
- As one of the focal aspects of the Mortgage Reform Act, and the qualified mortgage safe harbor, satisfaction of the ability to repay analysis will be closely scrutinized when loans enter the secondary market, and will likely be subject to testing by secondary market investors.

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Conclusion



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What have we learned?

Where are we headed?

What needs to be done for Originators to support the return of the Private Label Securitization market?

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THANK YOU!

Question and Answer



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