Davis Wright Tremaine LLP

ARE YOU MANAGING YOUR LOAN REPURCHASE RISK?

- by John R. Tate*

The Problem

As the rates of loan defaults and foreclosures continue to increase, mortgage brokers and originators face the growing risk that they will receive loan repurchase demands. This unpleasant prospect is rendered even more troublesome by the concurrent decline in revenue from new loans and refinancings which may limit the financial resources available to respond. Yet a surprising number of mortgage brokers and loan originators are unfamiliar with the nature and scope of their repurchase obligations. Due to the press of business over the last six years, many originators have executed a variety of loan placement contracts (sometimes known as "Seller Contracts" or "Customer Agreements") to increase their access to lending sources and expand the variety of loan programs they can offer. However, at the time of execution of these form contracts the repurchase provisions are often overlooked or poorly understood, resulting in a repurchase risk which now may endanger the loan originator's survival.

Far from being uniform, repurchase obligations can vary dramatically. Many mortgage brokers assume that their repurchase obligations are limited to instances of fraud or gross negligence. Similarly, mortgage bankers may believe that their repurchase risk is significantly lessened when the investor performs or oversees the underwriting on the loan. While some seller contracts contain such limitations, many do not, transferring most, if not all, of the credit risk to the originator regardless of the division of underwriting responsibilities. Since many investors delay repurchase demands until after the collateral has been liquidated and a deficiency has resulted, it becomes relatively easy for them later to challenge appraisals obtained prior to funding. Under some contracts a loan repurchase demand can arise even with sound

underwriting simply because of later events beyond the originator's knowledge or control such as the borrower's early default or failure to occupy non-investment property. Where the risk of loan default has been placed on the originator, every closed loan represents a contingent liability which may not expire for years.

<u>Assessment Of The Risk</u>

It is therefore prudent, if not essential, for loan originators to conduct an audit of their loan repurchase exposure to enable them to take defensive action now if warranted by the results. Expired or inactive contracts should be considered as well as current agreements if loans sold under their terms are likely to remain in force. Contract terms affecting loan repurchase obligations can be found in a variety of provisions in the governing documents. Some seller contracts contain a provision expressly labeled "Repurchase Obligation" while others contain provisions specifying the originator's representations and warranties. Contract provisions governing indemnification rights are also relevant. In some instances the applicable language is not to be found in the body of the seller contract at all, but in a separate guide or manual referenced in the contract. Although these guides generally contain loan program information and other seemingly unrelated materials, they often contain contract language as well. Finally, it is possible that important contract language may not be contained in any written documentation provided by the lender or investor, but may appear on their webpage instead. Without an awareness of the full range of the applicable terms, it is impossible for a mortgage broker or loan originator to assess the nature and scope of its repurchase risk and take the appropriate countermeasures.

If the contract language does not limit the originator's repurchase obligations to false or inaccurate loan information of which the originator "knew or should have known" or an equivalent limitation, the resulting exposure can potentially encompass every loan sold with insufficient collateral. Particularly troublesome are contract provisions that warrant that every loan conforms to all of the investor's applicable lending requirements and contains no defect which would cause an institutional investor to regard the loan as unacceptable. Such language is

not only broad, it is uncertain, providing investors with a flexible basis for issuing repurchase demands.

Once the contracts with troublesome language have been identified, a review should be conducted of the number of outstanding loans subject to their provisions. Fortunately, if more than four years have passed since funding, there is a good chance that many of the loans have been repaid through resales or refinancings. However, the mere fact that a repurchase demand has not been received in that time frame is not definitive since investor efforts to liquidate collateral can delay transmission of a repurchase demand for years. Consequently, if available, loan status information should be sought from the investor.

Initial Response

If the potential repurchase exposure is too high, several steps should be considered immediately. First, the loan originator may wish to obtain errors and omissions insurance coverage if it does not already have it. New coverage will not protect against known or suspected claims, but should cover unknown claims which may arise later. Second, the originator should review which investors are currently receiving loans. Because loan pricing and products may have changed since the contracts in question were entered, loan originators should ascertain the degree of product overlap and price disparity between investors. Is the degree of repurchase risk presented by the scope of repurchase obligations justified by the importance of an investor's loan products to the originator's business or the price paid for new loans? Future loan placement might favor the lender with an equivalent loan product, but a less onerous repurchase obligation. Finally, mortgage bankers should reconsider the advantages of selling loans to affiliates of their warehouse lender as the existence of a substantial number of loans on the warehouse credit line will significantly enhance the investor's leverage when a repurchase demand is made.

Disputing A Repurchase Demand

In a common scenario, the mortgage broker or other loan originator submits a borrower's loan application to a potential investor under a program in which the investor underwrites the loan. The lender's program may dispense with common loan documentation such as verifications of borrower employment or income or utilize an appraiser from the lender's approved list. The loan is then funded with servicing assumed by the investor or an affiliated third party. Several years later the broker or seller receives a repurchase letter advising it for the first time that the loan is in default and in many cases that the collateral has been liquidated at a loss.

At this point the broker/seller has critical decisions to make. First, if the broker/seller has errors and omissions insurance coverage, a claim should be made immediately. Since such insurance policies usually have "claims made" provisions, the claim must be reported in the policy year in which the insured first learns of the possible existence of an adverse claim. Delay until a lawsuit is filed may negate coverage under the policy. Such claims must be made even where the collateral has yet to be liquidated and hence the fact if not the amount of loss remains unknown. Such coverage may be denied due to the presence of a repurchase exclusion or the contention that the asserted claim is contractual in nature and therefore not covered. However, in some states such as California a claim for broker negligence exists independent of any concurrent contractual obligation and consequently can give rise to an insurable claim. Such coverage issues should be reviewed whenever purchasing or reviewing an errors and omissions policy.

The originator's response to a repurchase demand is usually a function of the amount in dispute, the status of the relationship with the lender/investor, and the grounds for repurchase asserted. Where it becomes necessary to defend such a claim, a variety of potential defenses may exist. The most direct arise from the terms of the contract itself. Even if the contract appears to cover the situation in question, a defense may exist where the contract contains conflicting or ambiguous provisions. Similarly, where the obligation to repurchase is based on provisions contained in different documents such as the contract itself and a referenced manual

or guide, the question arises as to whether the referenced document has been properly incorporated into the contract so as to constitute a binding obligation. Finally, if the manual or guide has been revised since the date of the contract, it is important to determine whether the lender has taken the proper steps for the revisions to have the force of a contract amendment.

Other defenses may arise from the circumstances surrounding contract formation since the form contracts utilized by lender/investors are rarely modifiable by any but the largest originators. If some contract documents such as manuals and guides were not provided at the time of contracting, the contract may be deemed an adhesion contract and, depending on the lender's practices, found to be unconscionable.

Inquiry into the underwriting and servicing of the loan can also uncover valid defenses. Where the lender/investor underwrote the loan it has an implied covenant of good faith and fair dealing requiring it to act in a competent and prudent manner. Given the extraordinary loan volume experienced in the past few years, some lender/investors have lacked sufficient experienced underwriters to process all loans submitted. At times the result has been less thorough review, deviation from company policy, and even utilization of unqualified persons as underwriters. A lender's failure to follow its own underwriting policies and procedures may negate the originator's repurchase obligation. Similarly, to the extent the investor or an affiliate provides the loan servicing, negligence in that role may also preclude originator liability or reduce the amount recoverable.

Defenses may also arise from the manner of liquidation of the loan collateral. Not surprisingly, in an era of appreciating collateral values, lenders often seek immediate liquidation of the collateral to recognize an immediate recovery and determine if any loss will result from the borrower's default. However, the method by which the collateral is liquidated may have profound consequences for the originator. In states with anti-deficiency laws, any action by the investor which has the effect of precluding a subsequent recovery from the borrower may exonerate the originator since its right to be reimbursed by the borrower for any payment made to the investor has been prejudiced. Finally, still other defenses can arise where the loan has been resold or assigned to the secondary market.

Awareness of each lender/investor's repurchase requirements can enable a mortgage broker or other loan originator to manage if not avoid future repurchase risk and protect itself from the fallout from defaulted loans. The sooner the necessary assessment is made, the better the precautions that can be taken.

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