Buybacks—

They're Not Going Away

— by BRIAN S. LEVY —

Repurchase demands are likely to continue. Here's why.

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One of the legacies of the 2007 subprime meltdown is the surge of mortgage repurchase/buyback demands that engulfed the industry from 2008 until today. From the government-sponsored enterprises (GSEs) pushing back mortgages on the largest of lenders, to those lenders, in turn, demanding repurchase by smaller correspondent originators, few terms invoke fear and anger from a mortgage lender quite like the word "repurchase. ¶ On March 19, 2012, an issue brief from the Mortgage Bankers Association (MBA) ("GSE Mortgage Buyback/Repurchase Requests") put the epidemic in perspective: "The volume of mortgage buyback/repurchase demands by Fannie Mae and Freddie Mac continues at unprecedented levels. . . . During the past three years alone, Fannie Mae and Freddie Mac have made close to $100 billion in repurchase demands." ¶ Even though recent updates to the representations and warranties demanded by both GSEs offer some relief from life-of-loan repurchase risks, a closer look reveals that the buyback era is far from over. ¶ As Rick Rothacker wrote in an Aug. 12, 2012, Reuters article, "Fannie Mae and Freddie Mac say they are trying to recover as much money as possible for taxpayers after receiving more than $188 billion of government support during the housing crunch. They have since repaid about $45 billion."

There is strong motivation for the GSEs to continue scrutinizing their portfolios and identify any number of grounds upon which they could make new claims.

While most recent repurchase demands focused on loans made between 2005–2008, and were premised on, essentially, negligent or improper underwriting at the origination level, future buyback demands will likely be based upon a number of new grounds.

The road to here: A brief history of repurchase demands

To better understand why mortgage lenders are not yet out of the woods, it would be best to review the evolution of the buyback demand. Loan sale agreements have long had a repurchase and indemnification remedy for breach of representation and warranty. These remedies were designed to enforce underwriting discipline and ensure consistency in originations, but not to transfer risk of loss.

Secondary investors and the GSEs first demonstrated an interest in these legal remedies in the 1980s, particularly in the wake of the savings-and-loan failures. During that period, most repurchase demands were based on instances of appraisal and income fraud or other fraud evident at the point of origination.

Unlike the buyback demands we have seen recently, however, the repurchase demands of the 1980s could be directly tied to the reason for default and loss. This is because stable or rising property values generally provided greater protection from losses for most loans in an investor's portfolio. Other issues such as lien position or property damage were often covered by insurance. Repurchase, then, was reserved for losses that could be directly traced to origination errors.

Buybacks were reinvented in a furious and unanticipated fashion on the heels of the market collapse of 2007–2008. Facing crippling home mortgage losses and a nearly unprecedented crisis in the financial system, the GSEs (themselves forced into federal conservatorship) and other loan investors began to scour the details of their agreements and portfolios to identify origination defects to pass the losses back down the chain. The repurchase remedy was the hook.

Unlike the past, where the losses could be tied to the origination defect, however, the recent use of the repurchase remedy ignored any such connection.

The result has been a historical wave of buyback demands. Unlike the mini-boom of repurchases in the 1980s, the most recent surge occurred in an environment of job losses and diminishing property values, exacerbating defaults and loss severity.

The vast majority of demands have focused on loans originated between 2005 and 2008, which were made at the peak of the valuation cycle while underwriting was at its most lax. When those loans defaulted, losses were enhanced by severe value declines.

The bulk of repurchase demands at that time were based on underwriting defects such as insufficient income and/or undisclosed debts, unverified and/or insufficient reserves or assets, faulty appraisals and the like. Calling upon the representations and warranties clauses standard to the sale of loans to investors, the GSEs, and subsequently the largest of mortgage lenders, began to push defaulted notes back downstream in the loan production channel.

A once highly collegial and relationship-based industry of sellers, buyers and servicers began to air its dirty laundry in litigation and other disputes over who should bear the massive losses underlying these repurchase claims. To address the reality, most originators now hold reserves aside, earmarked solely for repurchase issues.

Although recently the tight credit standards and rising tide of increasing property values have cooled the losses that drive repurchases, it would be a mistake to overlook the new risks that loom.

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As we have seen, the GSEs have billions of reasons to make additional repurchase demands. This is complicated by a political climate simultaneously demanding greater access to credit and GSE reform.

Despite the new GSE representation and warranty framework that would seem to limit repurchase exposure for underwriting deficiencies, a line has been crossed in the industry that cannot be ignored. With the divorce of cause and effect from the repurchase equation in the current wave, it is now clear that loan investors will not hesitate to pass back unanticipated costs and losses for any reason cognizable under applicable loan sale agreements regardless of "fault."

As a result, originators and downstream loan sellers need to maintain careful risk-management controls to anticipate and manage emerging risks.

Although the last stream of buyback demands was largely premised upon underwriting failures at the origination level, new regulations, enhanced quality-control reviews and tighter underwriting make it unlikely we will see similar demands in such numbers—at least in the next few years. Using the recent past as a guide, it is likely the secondary market will identify new reasons to force buybacks.

The QM standard: Safe harbor or latest repurchase risk?

In January 2014, a new era will dawn on mortgage lenders as they implement the requirements of the Consumer Financial Protection Bureau's (CFPB's) ability-to-repay rule (ATR) under the Truth in Lending Act (TILA) and seek to adhere to its Qualified Mortgage (QM) "safe harbor" standards.

ATR requires lenders to perform a reasonable and good faith confirmation of the borrower's ability to repay the loan and offers eight factors that must be assessed in that regard. QM provides a legal safe harbor confirming that loans meeting QM have satisfied the ATR test. While it is unclear whether the secondary market will have an appetite for loans that do not qualify for QM, the Federal Housing Finance Agency (FHFA) indicates that the GSEs will only purchase loans meeting the QM guidelines (e.g., 43 percent maximum debt-to-income ratio, 3 percent cap on points and fees, product limitations, and so on).

Because of the legal safe harbor QM provides from borrower claims and defenses, it is expected that loan purchasers will require new representations and warranties regarding meeting ATR and, in particular, compliance with the QM standard.

The ATR rule, however, does more than effectively kill stated-income lending; it creates massive potential litigation risks for lenders accused of failing to properly follow its requirements.

Although ATR only requires a "reasonable, good faith confirmation of ability to repay," proof of meeting this standard poses huge compliance uncertainties for the industry due to the subjectivity of those words. The litigation risk is acute because, in addition to providing for statutory and actual damages for up to three years after origination, borrowers can also use the failure to comply with ATR as a defense to foreclosure for the life of the loan. All of this means that in virtually every instance of borrower default, counsel for the borrower can seek to prove that the lender did not properly determine ability to repay at origination.

Lenders fought hard in Washington, D.C., to obtain the QM safe harbor to mitigate the risk of these lawsuits, but some of the definitions in QM are complicated and subject to mistake and misinterpretation. In fact, borrowers can still challenge the calculations factually (e.g., debt-to-income was really 44 percent and not 43 percent).

Just because a loan does not qualify for QM doesn't mean it fails the ATR, but unless lenders maintain and can produce (for the life of the loan) thorough and accurate ATR records, reliance on the safe harbor can be a trap resulting in TILA liability if income or debts are later successfully challenged by a borrower without there being any cushion.

There are several reasons repurchase will likely be demanded on loans failing subsequent investor/servicer QM reviews. First, because the cost, distraction and uncertainty around borrower and property litigation is significant, even if the lender is successful in defeating the claim, these are strong reasons for an investor or subsequent servicer to simply give the loan back to the originator to service the loan to bear such risks and costs.

Second, with respect to loans that are past the statute of limitations (three years) for the borrower to bring an ATR claim, the failure to meet the QM/ATR test can only be raised as a defense to foreclosure. Accordingly, returning the loan to the originator permits the originator to determine whether loss-mitigation efforts other than foreclosure would be more prudent to minimize losses by avoiding the risk of an ATR defense.

Finally, originators are in the best position to defend the ATR/QM calculation and to produce evidence needed to demonstrate compliance.

The repurchase implications of QM are now becoming evident. The CFPB has already stated that investor repurchase demands will not be dispositive of a borrower QM/ATR claim but, clearly, if an investor identifies a QM error and demands repurchase, one can expect that will be used against an originator in any borrower litigation.

QM and ATR representations and warranties will soon be added to standard loan purchase and sale agreements for 2014 and beyond. As a result, it is likely that originators (particularly those who sold servicing) will be seeing a new wave of repurchase demands arising out of QM/ATR compliance and/or litigation without regard to loan losses.

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Environmental issues: The 'ostrich defense' won't cut it

Since the late 1980s, commercial real estate lenders have required environmental reports as a standard underwriting condition. For various reasons, the residential market has been historically less stringent in that regard and almost never considers these risks. This was largely due to time and cost restraints prevalent in the early 1990s that have largely been erased by data and technological advances.

That said, most originators might not realize that Freddie Mac's *Single-Family Seller/Servicer Guide* requires that: "The appraiser *must* consider any known contaminated sites or hazardous substances that affect the property or the neighborhood in which the property is located. The appraiser *must* also note the presence of contaminated sites or hazardous substances in the appraisal report, make appropriate adjustments to reflect any impact on market value, and comment on the effect they have on the marketability of the subject property" (emphasis added by author).

Fannie Mae's *Single-Family Selling Guide* has a similar requirement with respect to known hazards. Typical loan and servicing sale agreements with large aggregators contain even more stringent representations and warranties regarding hazardous environmental conditions without any reference to the seller's knowledge.

Mortgage insurance coverage also can be jeopardized due to environmental issues with the insured property.

Meanwhile, myriad local issues identifiable in public records and ordinary news sources involving toxic environmental conditions such as vapor plumes emanating into residential

areas from manufacturing or dry-cleaning sites, oil and gas pipeline leaks, as well as uncertainties around environmental hazards posed by fracking-type operations all pose important questions for residential lenders to consider. Rarely, however, is any meaningful environmental research or analysis done before a residential loan is made.

Imagine the scenario in which a relatively established residential subdivision is unexpectedly subjected to damages from an environmental hazard that could have easily been discovered at the point of sale/origination with a simple search.

In such a scenario, any number of mortgages in the affected region could become unsalable or even prone to default and borrower litigation. Absent any upfront review, it would not be difficult for the current note holder (whether GSE or aggregator) to demand repurchase if such a condition is discovered that was present at the time of loan sale.

"For years, appraisers have simply checked 'none apparent' in the box on the Freddie and Fannie forms asking whether or not there are any adverse conditions on the property," says Marx Sterbcow, a mortgage and real estate attorney and partner with New Orleans–based law firm The Sterbcow Law Group. "I'm willing to bet that in 99.9 percent of those cases, neither the originating lender nor the appraiser could demonstrate that even the slightest effort was made to accurately come to such a determination."

Supporting this, the Statement of Limiting Conditions authored by Fannie Mae and present in nearly all residential appraisals states, "The appraiser has noted in this appraisal report any adverse conditions (such as needed repairs, deterioration, the presence of hazardous waste, toxic substances, etc.) observed during the inspection of the subject property or that he or she became aware of during the research involved in performing the appraisal."

"What has been missing for nearly two decades in the process has been 'research.' Appraisers might make note of visible contamination, but feasible research given publically accessible data does not happen," notes Francis X. Finigan, an independent appraiser, environmental consultant and president of Randolph, Vermont–based American Indoor Air Quality Assessment Services.

"This is about disclosure," Finigan adds. "The appraiser is viewed as the eyes and ears of the lender, from the secondary market's perspective. Not looking and not disclosing or reporting is a head-in-the-sand approach that is invariably going to come back to hurt both the appraiser and the lender."

Again, while property values may have stabilized on a national basis, should dangerous environmental conditions be revealed that should have been discovered prior to origination, originators may find themselves taking back these loans as repurchases.

Compliance-driven buyback demands

With compliance (including litigation and potential penalty costs) becoming perhaps the single biggest cost facing lenders and the enforcement environment becoming more active by the day, it is likely that future buyback demands will be based upon compliance errors at the origination level.

If the CFPB has set a tone in its first two years of existence, it is that it will not hesitate to penalize businesses it perceives to be doing wrong by the consumer. The bureau has been clear about this, and this theme could even eventually give rise to a new wave of buyback demands.

Servicers and investors identifying consumer compliance errors may seek to return problematic loans to originators rather than having to defend the matters in court or with aggressive consumer regulators such as the CFPB.

Needless to say, this opens up a Pandora's box of major proportions. Consider, for example, the possibilities that a defaulted mortgage was originated in violation of the Real Estate Settlement Procedures Act (RESPA), Truth in Lending Act or even Home Ownership and Equity Protection Act (HOEPA)—a very real possibility compounded by the numerous changes in the rules governing those statutes recently.

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Now, further consider the CFPB's ability to impose unprecedented fines or the ability of private, class-action attorneys to file litigation. The cost potential is enormous, and a strong case can be made that the GSEs, secondary investors or even larger purchasing lenders will be quick to push nonperforming mortgages back to the originator or correspondent lender rather than shoulder the cost of litigation or administrative action.

Although the mortgage industry has been given a chance to catch its breath momentarily, the surge in buyback demands is probably not over. With the floodgates opened and investors convinced that past losses can be mitigated with this tool, it is only a matter of further scrutinizing the contract language that bound the original sale of the mortgage.

The regulatory environment—with its expansive scope and its potential for enormous costs—will only further encourage this. As a result, lenders will probably need to carry on the trend of setting aside significant reserves as well as beefing up their origination processes at all levels to give themselves a fighting chance. MB

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