CREDIT COMMITTEES: CENTRAL HUB OF MORTGAGE BANKING

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Many clients have credit risk management committees, sometimes referred to as loan committees, lending committees, or credit committees. Let's just call them "credit committees" or, for the purposes of this article, "Committees." For small mortgage lenders, the Committees wind up consisting of the owner and perhaps a second company official. Howsoever this internal entity is configured, it is very important to ensure continuity between the origination process flow and, where possible, the interaction with a loan committee that sets policy standards and, as needed, makes decisions on whether to approve a risky loan transaction.

When we are retained by a client to review its departments and functions, for instance to conduct an internal audit or a GSE readiness audit – one of the factors we consider is the lending function itself. This activity is in fact actually distributed over many departments. But the loan flow process must come under a set of review criteria which, when challenged, often requires resolution by a committee constituted to manage the loan transaction's risk.

First and foremost, it is important to emphasize that an institution's quality control, compliance, and audit procedures should focus on mortgage lending activities that pose high risk. Controls to monitor compliance with underwriting standards and exceptions to those standards are especially important.

To break this down further, the quality control function should regularly review a sample of loans from all origination channels. A representative sample of underwriters should be subject to quality control auditing in order to confirm that policies are being followed. When control systems or operating practices are found deficient, business-line managers should be held accountable for correcting deficiencies in a

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timely manner. This means, in effect, that the deficiency should be identified, mitigated through system and training solutions, monitored, and periodically tested.

Since some loans permit a borrower to defer principal and, in some cases, interest payments for extended periods, institutions should have strong controls over accruals, customer service and collections. Servicing must be an intrinsic part of the loan committee's considerations. The exceptions made by servicing and collections personnel should be carefully monitored to confirm that practices such as re-aging, payment deferrals, and loan modifications are not inadvertently increasing risk. One suggestion would be to have servicing and collection personnel involved in the Committee. At the very least, servicing should be informed of credit decisions that affect its purview. Customer service and collections personnel should receive product-specific training on the features and potential customer issues with these products.

Third party originators ("TPOs") are always a challenge for financial institutions. In this group, I place such TPOs as mortgage brokers and correspondents. Institutions should have strong systems and controls in place for establishing and maintaining relationships with third parties, including procedures for performing due diligence. Oversight of third parties should involve monitoring the quality of originations so that they reflect the institution's lending standards and compliance with applicable laws and regulations. Monitoring procedures should track the quality of loans by both origination source and key borrower characteristics. This will help institutions identify problems such as early payment defaults, incomplete documentation, and fraud. If appraisal, loan documentation, credit problems or consumer complaints are discovered, the institution should take immediate action. Remedial action could include more thorough loan application reviews, more frequent re-underwriting, or even termination of the third-party relationship.

For the balance of this article, I will describe some primary vectors that require the Committee's attention. Comprehensive procedures should be utilized to evaluate credit risk on a bulk or transactional basis. Important in drafting such procedures is taking into consideration a financial institution's size, complexity and risk profile.

CREDIT COMMITTEES AND SECONDARY MARKET ACTIVITY

The interface between credit risk and secondary market management pertains to several factors, most prominently that the procedures should be commensurate with the nature of the loan products and volume of loan origination activity. When Lenders Compliance Group reviews for secondary market compliance, we always look to ensure that the client has comprehensive, formally ratified strategies for managing risks. Also, I recommend that various "contingency plans" be included in how the institution will respond to reduced demand in the secondary market.

Third-party loan sales are never without some metric that reflects the measurement of risk: even if a company transfers a portion of the credit risk, it remains exposed to reputation risk when credit losses on sold loans or securitization transactions exceed expectations. As a result, promulgate possible contingency

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plans for instances where an institution may deem it necessary to repurchase defaulted mortgage loans to protect its reputation and maintain access to the markets.

From the point of view of a regulator, the repurchase of loans beyond the selling institution's contractual obligation is an implicit recourse. Under risk-based capital rules, a repurchasing institution would be required to maintain risk-based capital against the entire pool or securitization. Institutions should familiarize themselves with these guidelines before deciding to support loan pools or buying back loans in default.

CREDIT COMMITTEES AND MANAGEMENT REPORTING

I can't overstress the importance of management reporting and the periodic testing of the reporting systems. Know the risk profiles of all loan products and provide full accounting of any changes to such risk! For instance, if the company originates non-traditional mortgages, reporting systems should allow management to detect any subtle changes in the risk of this product's loan portfolio. Among the metrics that should be reported to management are the elaboration of key loan products, risk-layering loan features, and certainly borrower characteristics. Reports should also provide metrics that show the statistical delta for deteriorating performance in any of the foregoing areas, surely before any such deterioration has progressed to a point of substantial impact to the portfolio's or the company's financial stability.

Here's a brief outline of the types of information that should be set forth in detail in the management report for risk. As an example, the report would include, but not be limited to:

- Loan type (i.e., interest-only loans and payment option ARMs);
- Risk-layering features (i.e., payment option ARMs with stated income and interest-only loans with simultaneous second-lien loans);
- Underwriting characteristics (i.e., LTV, DTI, credit score); and,
- Borrower performance (i.e., payment patterns, delinquencies, interest accruals).

A good report would contain portfolio volume and performance metrics that track forecasts, internal lending standards and policy limits. The construct of the report should dig deep into the volume and performance metrics, even to the sub-portfolio and aggregate portfolio levels.

Many Committees do not know how to evaluate statistical findings, such as regression analysis. However, most people seem to have an intuitive feel for variance analyses, which should be performed regularly to identify exceptions to policies and prescribed thresholds. So, the Committee should be given a report with variance analysis, inasmuch as it is critical to the monitoring of portfolio risk characteristics and is an integral part of establishing and adjusting risk tolerance levels. Without careful review of such analyses, it is really a lost cause to try to determine how actual performance deviates from established policies and thresholds.

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CREDIT COMMITTEES AND STRESS TESTING

Since the huge mortgage meltdown a few years ago, there has been much banter about stress tests. But, if you think about it, these tests are just a form of sensitivity analysis. There is no good reason why competent management would not want to conduct a sensitivity analysis! The fact is, a financial institution shouldn't skate away from such analytics. Based on the size and complexity of the lending operations, banks and nonbanks should perform sensitivity analysis on key portfolio segments to identify and quantify events that may lead to an increased risk in a segment or the entire loan portfolio.

The typical drivers to sensitivity analyses can be based on many factors, but for lenders in particular the following metrics would be contained in a stress test report:

- Interest rates;
- Employment levels;
- Economic growth;
- Housing value fluctuations, and
- Other factors beyond the institution's immediate control.

If one or more of these metrics deteriorate – especially if they deteriorate rapidly! – there might be an immediate need to assess the potential influence on default rates and loss severity. Where sensitivity evaluation is on-going, the company is in a better position to identify, monitor and manage risk, and, mutatis mutandis, move assertively to develop appropriate and cost-effective loss mitigation strategies. The stress testing results should provide direct feedback in determining underwriting standards, product terms, portfolio concentration limits, and capital levels.

CREDIT COMMITTEES AND ALLL

Our bank clients are familiar with ALLL, which stands for "Allowance for Loan and Lease Losses." But nonbanks would be wise to make ALLL part of their Committee reviews. Put simply, all financial institutions, to the extent applicable, should establish an appropriate allowance for loan and lease losses for the estimated credit losses inherent in their loan portfolios.

I tell our bank and nonbank clients to consider the higher risk of loss posed by layered risks when establishing their ALLL parameters. In preparing the layered risk metrics, financial institutions must realize that a limited performance history with any loan products, particularly in a stressed environment, increases performance uncertainty. Capital levels should be commensurate with the risk characteristics of the loan portfolios. Sloppy or overly malleable underwriting standards or poor portfolio performance may warrant higher capital levels.

In coordination with the company's Board of Directors or Management, the Committee should establish an appropriate ALLL that takes into consideration the adequacy of capital, and, where needed, loan

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portfolios should be segmented into pools with similar credit risk characteristics. The basic segments typically include:

- Collateral and loan characteristics,
- Geographic concentrations, and
- Borrower qualifying attributes.

But, segmentation should not stop there. Many institutions differentiate loans by payment and portfolio characteristics, such as:

- Loans on which borrowers usually make only minimum payments,
- Loans with existing balances above original balances, and
- Loans subject to sizable payment shock.

The ideal objective is to identify credit quality indicators that affect the gathering of information for ALLL measurement purposes. If future loss exposure is to be mitigated adequately, thereby leading to adjustments in the capital levels, deriving the characteristics which influence expected performance is an exercise that must be undertaken.

My firm is retained by financial institutions with material mortgage banking activities and mortgage servicing assets. We guide them through the maze of applying sound practices in valuing the mortgage servicing rights for virtually all mortgage loan products. This valuation should also not be neglected in ALLL and should follow generally accepted accounting principles, using reasonable and supportable assumptions.

CREDIT COMMITTEES AND CONSUMER PROTECTION

Fundamentally, the Committee is not only a bulwark for the institution but also acts as a means by which the mortgage loans can be evaluated for responsiveness to consumer needs as well as flexibility with respect to borrower eligibility. I can tell you from experience that regulators are very concerned that consumers may enter into loan transactions without fully understanding a loan product's terms. If you think you can rely on disclosures alone to fulfill your obligations to consumer protection, you couldn't be more mistaken.

For instance, certain loan products have been advertised and promoted based on their lower initial monthly payments compared with other types of loans. In this case, the Committee should be reviewing the advertisements for the loan products. In a year's time, my firm receives hundreds of advertisements for review before initiating any contact with the public. Our clients submit the advertisements for our guidance as a critical component of their new and existing loan product reviews. For instance, the Committee should task itself with evaluating promotional materials and other product descriptions to ensure that information about the costs, terms, features, and risks can assist consumers in their product selection decisions.

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The Committee should be vetting all modalities involving consumer protection, on a product by product basis. Indeed, any relevant loan product information relating to consumer protection should be provided to the Committee in a "timely manner," which I would describe as a timeframe before disclosures may be required under any federal or state regulatory framework.

In light of these risks, institutions should implement the following communications directives:

- Communications with consumers, including advertisements, oral statements, promotional materials, and monthly statements, should provide clear and balanced information about the relative benefits and risks of these products, including the risk of payment shock and any other foreseeable risks.
- Clear, balanced, and timely communication to consumers of the risks of loan products will provide consumers with useful information at crucial decision-making points, such as when they are shopping for loans or deciding which monthly payment amount to make.
- The minimization of potential consumer confusion and complaints, the fostering of good customer relations, and the reduction of legal and other risks to the institution.

It bears stating that every loan product review must ensure that all facets of its structure and origination process comply with all applicable laws and regulations. Federal and state laws, including laws regarding unfair, deceptive or abusive acts or practices, may apply.

The Committee's purview is strengthened when the learning curve keeps narrowing based on experience. If a promotion leads to an incidence of potential concern to consumer protection, the Committee can use the knowledge thus gained by being more attentive to providing consumers with information that is designed to help them make informed decisions when selecting and using the loan products. Meeting this objective requires appropriate attention to the timing, content, and clarity of information presented to consumers.

For example, if the Committee learns that there are better timeframes for providing consumers with information that will help them in selecting products and choosing among payment options, an adjustment in such notification can be made when a consumer is shopping for a mortgage or at the point of sale. In other words, consumer protection is active when the consumer makes an inquiry to the institution about a loan product and receives information about it, or when marketing relating to loan products is provided by the institution to the consumer – not just upon the submission of a loan application or at consummation.

I have noticed certain consumer protection issues coming up time and again in Credit Committee meetings. I have sat on bank Audit and Examination Committee meetings and, where my firm has been retained to conduct an internal audit, I include these incidences in my report. Here are but a few incidences that our audits have shown as being reported to the Committee:

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- Giving consumers unwarranted assurances or predictions about the future direction of interest rates (and, consequently, the borrower's future obligations);
- Making one-sided representations about the cash savings or expanded buying power to be realized from certain loan products;
- Suggesting that initial minimum payments will cover accrued interest (or principal and interest) charges; and,
- Making misleading claims that interest rates or payment obligations are "fixed."

CREDIT COMMITTEES AND ADMINISTRATION

Virtually all parts of the loan flow process, from point of sale to securitization, should come under the Committee's purview, where it can develop and use strong control systems to monitor that actual practices are consistent with the policies and procedures relating to the loan products – which brings me to the subject of the range of control systems and pathways needed to address compliance and consumer information concerns as well as safety and soundness considerations.

The Committee must ensure that lending personnel are trained so that they are able to convey information to consumers about product terms and risks in a timely, accurate, and balanced manner. As products evolve and new products are introduced, lending personnel should receive additional training, as necessary, to continue to be able to convey information to consumers in this manner. Lending personnel should be monitored to determine whether they are following these policies and procedures.

In addition, the Committee should receive real time and periodic reports of any reviews relating to consumer complaints. Without such information, the institution has no internal group that is centrally able to identify potential compliance, reputation, and other risks involving the extension of credit. Attention should be paid to appropriate legal review and to evaluating compensation programs to ensure that they do not improperly encourage lending personnel to direct consumers to particular products.

With respect to loans that an institution makes, purchases, or services using a third party, such as a mortgage broker, correspondent, or other intermediary, the institution should take appropriate steps to mitigate risks relating to compliance and consumer information. Therefore, the Committee should be empowered to take steps to manage third-party originations risks, such as:

- Conducting due diligence and establishing other criteria for entering into and maintaining relationships with such third parties;
- Establishing criteria for third-party compensation designed to avoid providing incentives for originations inconsistent with this guidance;
- Setting requirements for agreements with such third parties;
- Establishing procedures and systems to monitor compliance with applicable agreements, institution policies, federal and state regulations and laws; and,
- Implementing appropriate corrective actions in the event that the third party fails to comply with applicable agreements, institution policies, or laws.

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The Credit Committee should be considered the point of convergence and central hub of the management function. All departmental roads should lead to it! A financial institution that simply relies on the loan origination process to move along like cakes on a conveyor belt is sooner or later going to be caught up in its own complacency.

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