MANDRIEN CONSULTING GROUP

REAL ESTATE SERVICE INDUSTRY

Evolution of the New Compliance and What You Need To Know

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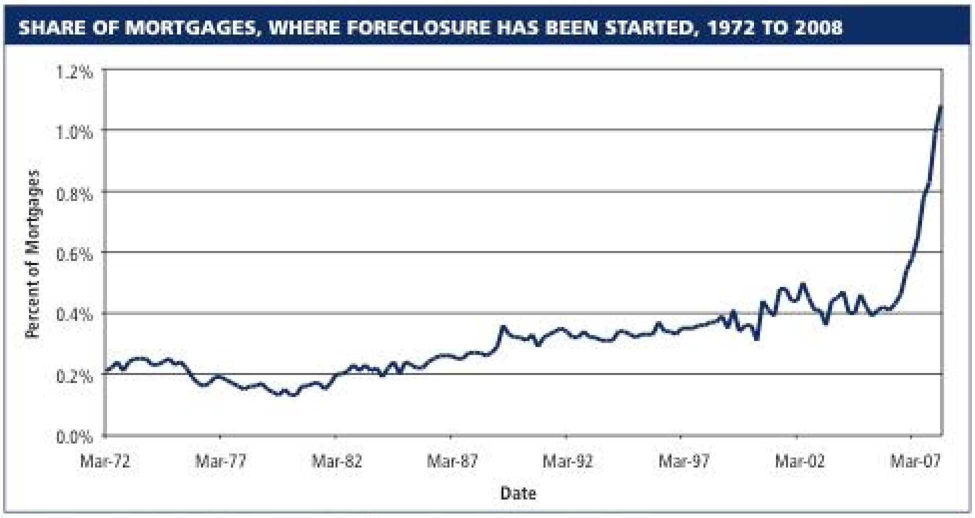
BRIEF OVERVIEW OF "THE CRISIS"

The first clue of the series of events now commonly referred to as the "credit crisis" became public knowledge in 2006 with the reporting of an unprecedented rise in home foreclosures. Soon thereafter the headlines exploded with the news that the common stock of the country's most prominent subprime lender, New Century Financial, fell 83% pending Justice Department investigations. Ultimately New Century succumbed to the filing for bankruptcy with liabilities exceeding $100 million. The ripple effect of this perfect financial storm was responsible for a national financial crisis that infected the global markets in less time than a year. The results were astounding. Consumer confidence was shaken, the residential housing market collapsed, and foreclosure became the norm not the exception, all of which led to a stock market crash, the magnitude of which has not been seen since the great depression. From this confluence of unfortunate events was born increased consumer awareness, government investigations and legislative debate over the root causes as well as mass speculation on where we go to fix the problems underpinning this crisis. The answer lies in regulatory compliance. In this article we will take a look at the evolution of the problem, the remediation process, and what technology companies are doing to help.



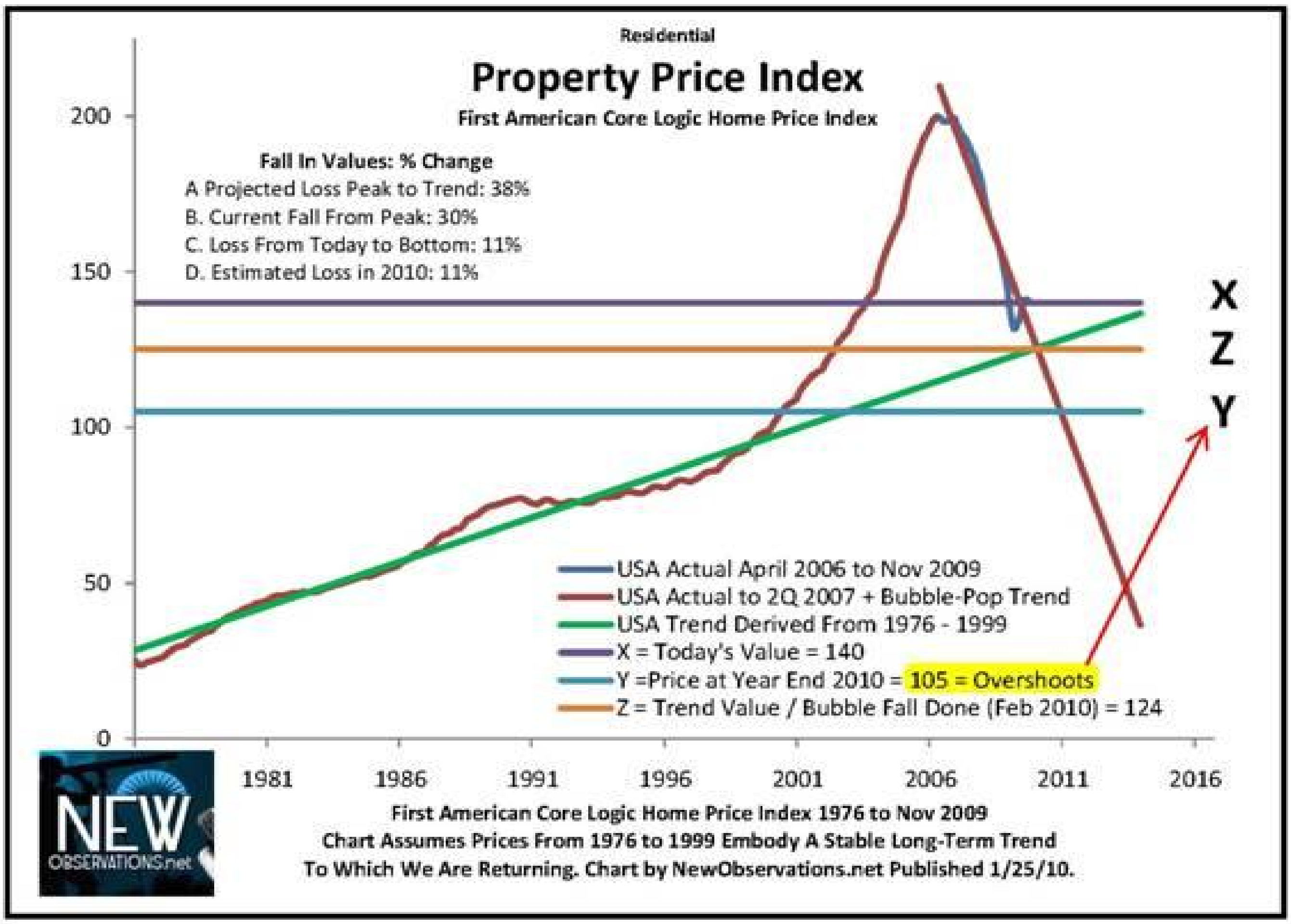
Source: Mortgage Bankers Association, 2008, National Delinquency Survey, Washington, D.C.: MBAA.

THE HOUSING BUBBLE AND ITS GENESIS

It all began with the disintegration of the residential housing market that had gone parabolic since 2001 after the Federal Reserve Board effectively reduced interest rates to zero in response to the World Trade Center attacks. A housing bubble is an economic bubble that occurs in local or global real estate markets. In general, a bubble occurs when speculation causes price to increase, thus producing more speculation. Price then reaches absurd levels and the bubble is usually followed by a sudden and unforeseen dramatic decrease in prices more commonly referred to as the "crash".

Economic bubbles are generally considered to be dangerous because they cause misallocation of funds into speculative markets. In addition, the crash which follows a bubble will predictably destroy a large amount of wealth and cause continuing economic problems as was the case of the Great Depression in the 1930s and the case of Japan in the 1990s. Another important characteristic of economic bubbles is their impact on spending habits. People will spend more because they "feel" richer during the bubble. The cause of bubbles is in some dispute. However, it is generally accepted that there is a "true value" to an asset, and that bubbles represent a speculative risk taking well in excess of true value, which must eventually return back to the mean or real valuation.

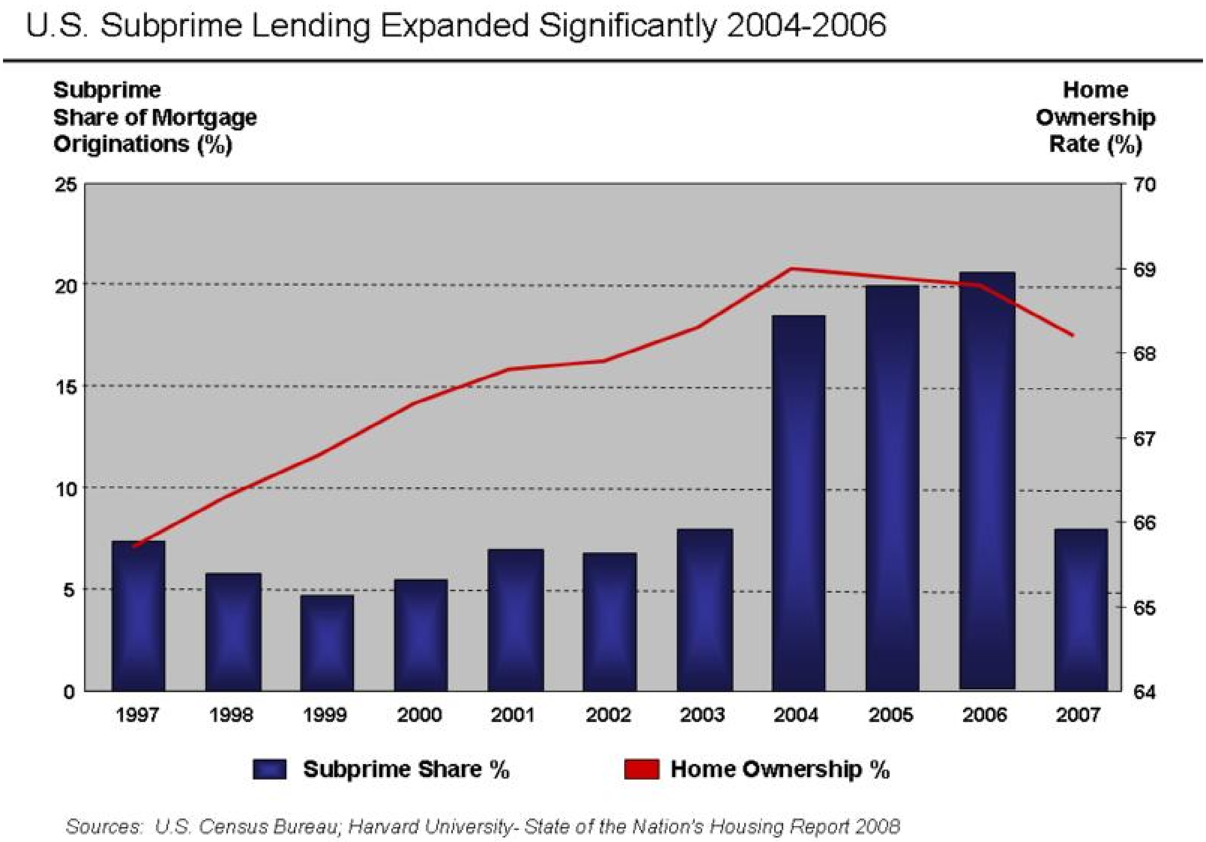
The current bubble was evidenced by artificial inflation of real estate prices until unsustainable levels were reached causing a return to the norm. Following the parabolic price increases are likewise dramatic decreases in real estate values which eventually lead to catastrophic situations throughout the housing market.



CAUSES OF THE MORTGAGE CRISIS

Subprime lending

Subprime lending was a substantial contributing cause in the increase in home ownership in this country. The demand for housing during the years leading up to the mortgage crisis was astronomical. The home ownership rate in this country increased to an all-time high peak of 69 percent in 2006. This demand caused housing prices to ascend and increased consumer spending resulting in appreciation in home values to never before seen levels. Many took advantage of the extraordinary inflated property values to refinance their homes with risky hybrid mortgages along with second mortgages against the added value to use for luxury spending. In turn, U.S. household debt as a percentage of income rose to likewise unheard of levels, much higher than the average amount when compared to debt to income ratios just a few years earlier. Contemporaneously with the bursting of the housing bubble came high mortgage default on various risk mortgages including but not limited to subprime, adjustable rate, Alt-A and other mortgage loans made to less credit worthy borrowers. The share of subprime mortgages to total mortgages increased to 20 percent in 2006. Subprime mortgages totaled $600 billion in 2006, accounting for approximately one-fifth of the U.S. home loan market.



Hybrid Mortgages and the birth of "flexible underwriting"

With the appearance of unregulated lenders coupled with hybrid mortgage products that traditional banks refused to sanction, experts believe these factors should have provided insight that a problem was at hand and therefore a need for oversight and regulatory compliance in order. Adjustable rate mortgages otherwise known as ARMs, interest-only mortgages and "stated income" products were but a few of the myriad "solutions" offered to borrowers who were not suited for traditional loans. "Stated income" mandates that the borrower does not have to provide bona fide proof to substantiate the income referenced on the application to refinance or purchase a home. In many areas of the country, especially those regions with the greatest price point rise during the bubble days, these non traditional loans went from being the exception to the norm. Another example of turn the cheek lending were seller-funded down payment assistance programs. This solution was one in which a seller gives money to a charitable organization that then gives the money to buyers. During the bubble hundreds of thousands of buyers got their down payments via this mechanism. According to the Government Accountability Office (GAO), there are much higher default and foreclosure rates for these types of mortgages. Eventually, the Internal Revenue Service ruled that these plans are no longer eligible for non-profit status. Lastly HUD adopted regulations prohibiting seller-funded down payment programs.

Mortgage brokers and automated underwriting

Mortgage brokers, who act as intermediaries between borrowers and lenders, do not lend their own money. There is therefore no causal connection between loan integrity and their compensation. Brokers, during this period, were also given incentives in the form of greater commissions for selling adjustable rate mortgages. Statistically in 2004, mortgage brokers originated approximately 68 percent of all residential loans in the United States, with subprime and Alt-A loans accounting for over 42 percent of the volume. Mortgage underwriters determine if the risk of lending to a borrower under certain parameters is acceptable. . In 2007, 40 percent of all subprime loans were generated by automated underwriting. Automated underwriting proscribed less documentation and expedient decisions.

Many mortgage experts believe that lax controls and corporate mandates to rely on automation led to the approval of buyers that would not have otherwise been approved with more traditional underwriting methods.

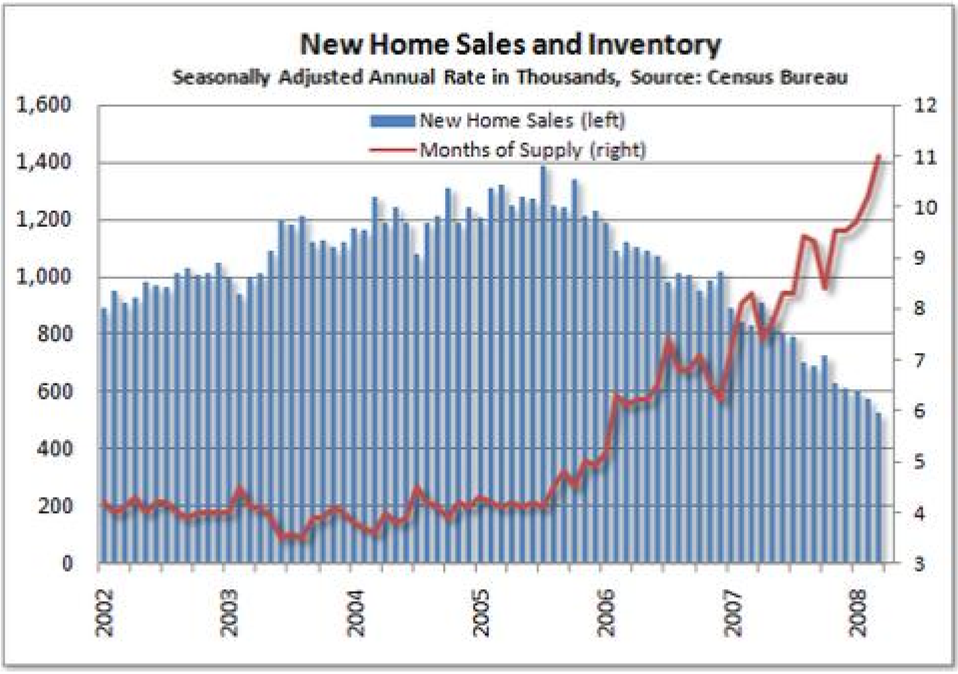
Actions of the Federal Government

It is well established that one of the causes of the housing bubble commenced in part by abnormally low interest rates. In this regard the rippling effect of the dot-com crash is still being felt today as well as the actions by the Federal Reserve to the attack on the World Trade Center. In response to these events which shook the world markets causing multiple stock market crashes, the Federal Reserve reduced short-term interest rates to less than 1 percent to prop up the United States stock markets. While there is no absolute and direct correlation between short term interest rates and mortgage rates, there is an indirect connection as mortgage rates customarily are set in relation to 10-year Treasury bond yields that are swayed or biased by federal funds rates. It is generally accepted and the government has acknowledged the connection between interest rate deflation, ascending home prices and the increased liquidity that the higher home values bring to the overall economy.

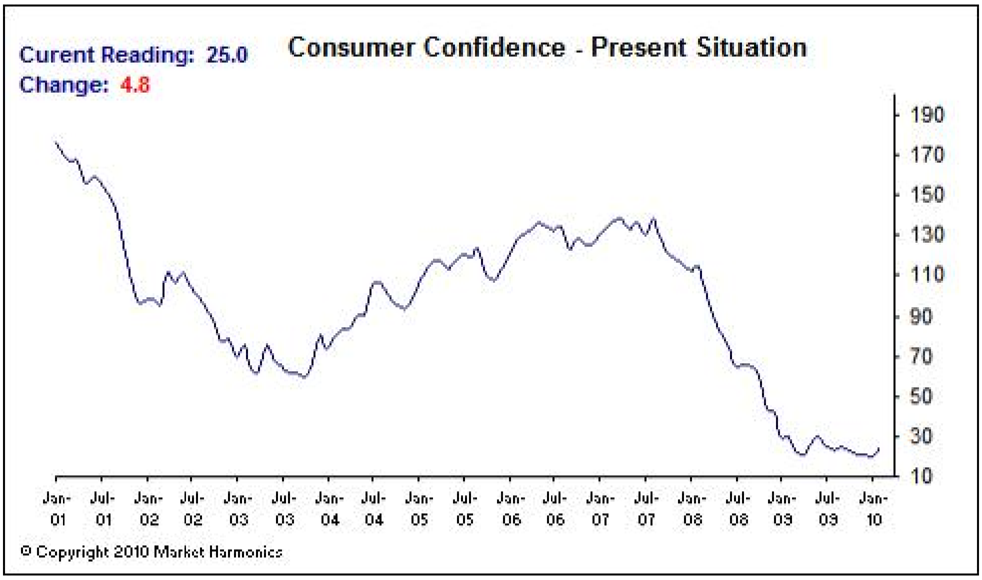
CONSEQUENCES – THE FALLOUT

Housing market deflation

The roaring housing market stopped suddenly for many areas of the country in early fall of 2005, and as of March, 2006, many regions faced swelling inventories, price deflation, and anemic sales' volumes. By summer of 2006, a common theme in the press was the warning of a "crisis". Prices of new homes were dropping, new-home inventories were at all time highs, existing-home inventories were high, and sales were down. Several home builders revised their forecasts sharply downward during summer 2006. The new home market also suffered. The biggest year over year drop in median home prices since 1970 occurred in April 2007.



Based on poor sales figures and falling prices economists espoused that the residential real estate market was free falling and would derail the rest of the economy, causing a recession in 2007. Many other economists agreed, consistently opining that the United States would enter a recession as house prices deflated. The duration and size of the slow down or recession, would depend in principle on the strength of consumer spending, which made up a large part of the economy. The sudden disappearance of the wealth effect coupled with the housing slow down could drastically affect consumer confidence and provide further resistance for the US and global economies.



Collapse of the Mortgage market

In March 2007, the United States' subprime mortgage industry imploded due to burgeoning home foreclosures, with virtually all subprime lenders seeking bankruptcy protection, announcing unprecedented losses, or reaching out for help from third parties in order to remain solvent as was so poignantly evidenced by the infamous facts surrounding New Century Financial. One esteemed Wall Street analyst cautioned that the subprime mortgage fallout was not “isolated” will severely diminish the stability of the US economy, and the end game will be the deflationary effect on home prices.

In the midst of the mortgage industry implosion, Senator Chris Dodd, Chairman of the Banking Committee held hearings and asked executives from the top subprime mortgage companies to testify and explain their lending practices; Dodd said, "predatory lending practices" endangered the home ownership for millions of people. Moreover, Democratic senators proposed a federal government bailout of subprime borrowers in order to save homeowners from losing their residences. Republicans asserted that government bailout of subprime borrowers is not in the best interests of the U.S. economy because it will simply set a poor precedent and worsen the speculation problem in the housing market.

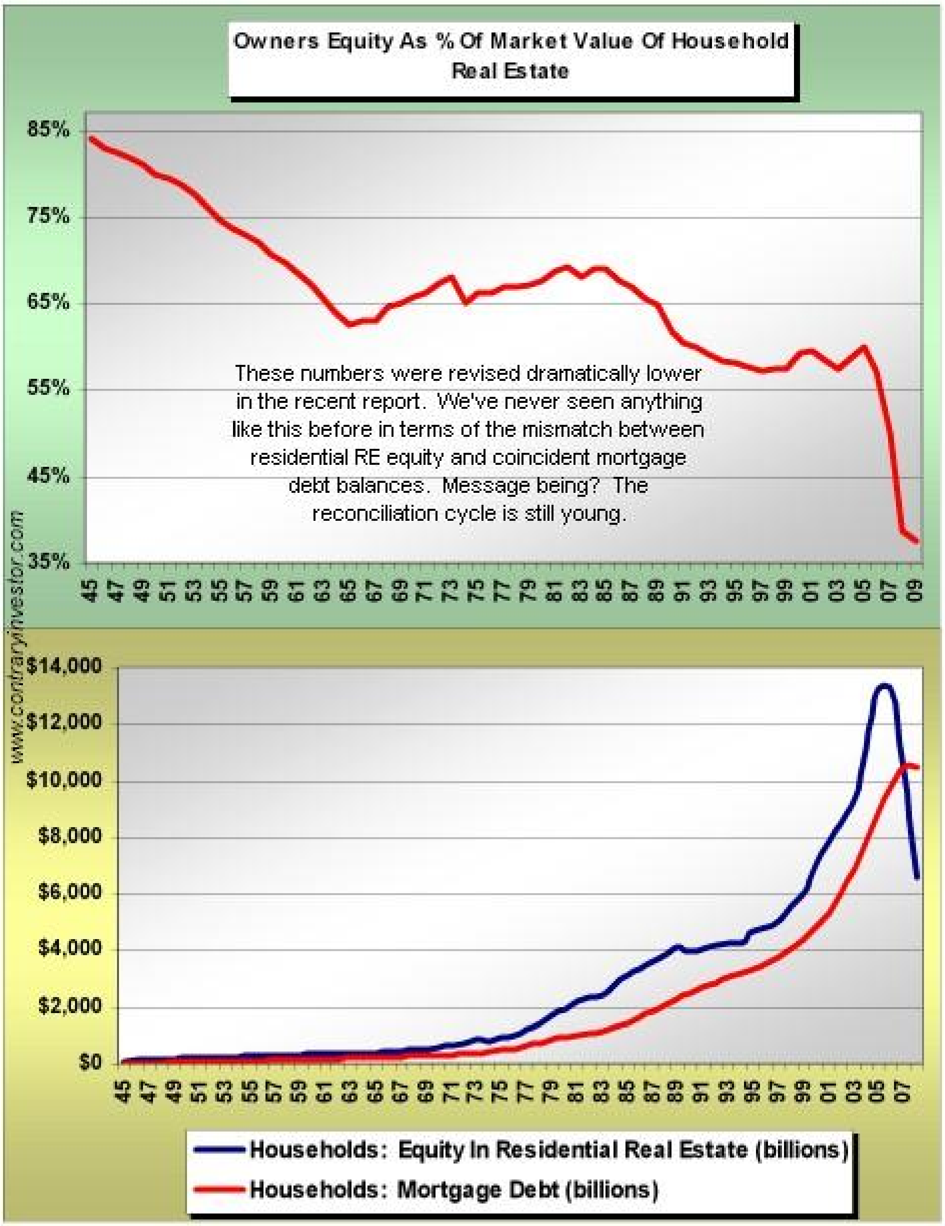
Foreclosures on the rise and “good” borrowers hurt as well

It was reported in the summer of 2007 that the number of residential mortgage foreclosures jumped 9 percent from June to July 2007, surging 93 percent over July 2006. Foreclosure activity jumped a staggering amount in August 2007, soaring 115 percent over August 2006 and 36 percent over July 2007. The rest is history.

As home prices continue to fall and banks tighten their lending standards, people with prime credit histories now are falling behind on their payments for home loans and other credit sources such as credit cards and unsecured loans. Consistent with the theme at this time in mortgage lending history, many prime originations allowed the borrower to reduce down payments and look forward to higher adjustable payments in the future. The premise was as long as price ascended, prime borrowers could refinance or sell their properties to pay their mortgage debt. With quickly descending prices and draconian lending standards, homeowners with stellar credit were beginning to feel the same financial stress as those with subprime credit.

Negative home equity across the country

In the Spring of 2008, the Fed stated that home equity had cumulatively fallen below 50 percent for the first time in history. Homeowners’ percentage of equity declined to 48 percent in the fourth quarter of 2007– the third straight quarter it was under 50 percent. The decline means that for the first time since the Fed starting tracking the data, in 1945, homeowners’ debt on their houses exceeds their equity. Economists expect the figures to drop even further as declining home prices strike at the value of most Americans’ single largest asset. Moody’s Economy estimated that 8.8 million homeowners, or about 10.3 percent of homes, would have zero or negative equity by the end of March 2008.



GETTING "COMPLIANT"

It is abundantly clear that economists and analysts have come to understand the causes of the credit crisis. The resulting aftermath has been empirically documented. Senate committees, regulators, industry experts and others have witnessed its catastrophic effect on U.S. and global economies. The next question is: how do we resolve the issues implicit in this highly complex state of affairs. Unfortunately there is no simple answer. The search for resolution has caused an outcry from political groups and lobbyists as well as a great debate among experts as to where the "fix" should begin.

Compliance status quo

The current status quo has left the mortgage and other related industries in a state of disarray. The companies that have survived this perfect storm must now face the consequences of their past lax compliance practices. The current landscape is difficult at best. Lenders are trying to avoid requests from investors looking to "kickback" toxic loans. Further, they are dealing with an onslaught of defaults and foreclosures. To complicate matters, borrowers are looking for a safe haven to help them from loosing their homes through legal aid or loan modification.

Mortgage company compliance is now a complex and somewhat daunting situation. Prior to the crisis, "compliance" translated to 1) processor training and education 2) document symmetry and 3) simplistic calculations engineered into operating platforms. After a loan closed there was a post production quality assurance function, which was based upon random sampling, not automated, and subject to human error. The major issue with these post production QC paradigms is that they did not eradicate compliance issues up front. It simply assessed how good or bad the situation was. Stated otherwise, post production compliance did not stop compliance errors but merely demonstrated how much risk a company might be absorbing.

This forensic way of dealing with compliance was obviously ineffective and doomed to fail, which it did. As we have seen, a revolution has occurred and with it has come dramatic and complex reform designed to protect the consumer. Mortgage companies, title agents and real estate service providers are all subject to a massive and quickly expanding potpourri of federal and state laws governing items such as fees, disclosure, escrows, interest rate, amortization and predatory lending.

This up front compliance requirement has now created significant risk and has made necessary the creation of more sophisticated tools through technology. Automated compliance search engines and analysis systems which efficiently review loan information up front for compliance with applicable laws has become mandatory in this new era of compliance. Compliance tools have required lenders to conform to serious design changes in their software solutions. By incorporating front-end compliance tools through integrating such items into their operating platforms originators can reduce risk and lessen post production quality review.

New Respa law

The adoption of new laws on the state and federal level have occurred on many fronts. The U.S. Department of Housing and Urban Development (HUD) recently issued new rules that modify the Real Estate Settlement Procedures Act (RESPA). RESPA is a consumer-protection statute that was enacted to (1) aid consumers/potential borrowers to become savvy shoppers of settlement services and (2) eliminate kickbacks and referral fees that illegally increase the cost to close. Loans secured with a mortgage placed on a one-to-four-family residential property are governed by RESPA. These loans include most purchase loans, assumptions, refinances, property improvement loans, and equity lines of credit. HUD's Office of RESPA is responsible for enforcing the law.

The following new RESPA rules became effective on January 1, 2010. First, the Good Faith Estimate (GFE), which is an estimation of closing costs provided by lenders to prospective borrowers, was revised to provide greater disclosures of estimated costs. As of January 1, 2010, loan originators, including mortgage lenders and mortgage brokers, must provide to qualified borrowers the new standardized GFE—which is now a three-page document—within three business days of the borrower's application. The GFE form includes a summary of key loan terms as well as an estimated cost of a list of mandatory settlement charges. The key loan terms that must now be included on the GFE include: (1) the initial loan amount; (2) the loan term; (3) the initial interest rate; (4) the initial monthly mortgage amount owed for the principal, interest and mortgage insurance; (5) whether the interest rate, loan balance and monthly payment may rise and (6) whether the loan has a prepayment penalty or balloon payment.

The new GFE also provides limits or "tolerances" on how much a charge can change from the issuance of the GFE to the actual closing of the loan. Depending on the type of settlement charge, the estimation of a settlement charge may either (1) not be changed from the issuance of the GFE to closing (the "First Bucket"), (2) increase up to 10 percent of the listed amount from the GFE to closing (the "Second Bucket") or (3) change without regard to the amount originally stated on the GFE (the "Third Bucket").

Examples of charges in the First Bucket include a lender's origination fee or a charge for an interest rate selected. Examples of charges in the Second Bucket include title administrative charges and lender's title insurance policy and appraisals. Examples of charges in the Third Bucket include daily interest charges, costs of homeowner's insurance and lender-required services where borrowers shop for and select their own third-party providers. The intent of the new GFE is to disclose to consumers all settlement charges and the costs for settlement services. The new GFE charges must be good for 10 business days, to allow the consumer to comparison-shop. The new GFE must be used by all loan originators as of January 1, 2010.

In addition, the new RESPA rules establish a new HUD-1 Settlement Statement (HUD-1). All settlement charges on the GFE must be reflected on the new HUD-1. The purpose of the new HUD-1 is to allow consumers to directly compare the fees identified on the GFE to those fees charged at the closing of such loans. The new HUD-1 consists of three pages. Compared to the earlier version of the HUD-1, there are no significant changes on the first page of the new HUD-1. However, numerous changes were made in the second page of the new HUD-1 to reconcile the changes enacted in connection with the new GFE. For example, a lender's loan-origination charges are bundled on line 801—listed as "our origination charge"—and are no longer itemized separately. The charge to the buyer for "title services" and "lender's title insurance" is disclosed concurrently on line item 1101 of the new HUD-1; however, any title fees paid to third-party providers must be itemized. The new HUD-1 now also requires the title-insurance premium split between the title agent and the title underwriter to be disclosed on line items 1107 and 1108. The third page of the new HUD-1 consists of a GFE-HUD-1 chart that compares the GFE estimated charges to the actual charges on the HUD-1, as well as a loan-term table. The charges must be within the tolerances, as explained above. As of January 1, 2010, all closing agents must use the new HUD-1.

GFE requirements require accurate fee delivery upfront

The duty of disclosure owed the borrower was the main driving force behind the disclosure requirements on the new GFE. Noteworthy is that HUD made lender concerns a priority when updating the GFE-related requirements. Notwithstanding these policy considerations, the new GFE protocol increases risk to lenders in many respects — especially those that fail to seek education and training as well as integrate a flexible, automated and accurate software solution to aid in mitigating risk.

The GFE law mandates that lenders furnish potential borrowers with the new revised GFE within three days of receiving the initial intake information. However, as an incentive to explore other loan options, lenders cannot press for verification of the provided information until the mortgage applicant gives permission to do so.

If the lender acquires newly discovered information that would cause modification to the GFE calculations, it can freely modify subject to the "changed circumstances" exception that has been created by the new rule. Changed circumstances are defined as follows: act of God, war, disaster/emergency, loan information change, newly disclosed borrower information previously unknown, and unusual title concerns. If the change falls within these categories, the amended GFE shall be forthcoming within three days. In all other circumstances, the first GFE will control.

The new GFE rule was designed to vigorously provide incentive to lenders to insure that the GFE is accurate thereby providing the consumer with the ability to make accurate comparisons in the process. If processors are careless and the GFE is likewise incorrect, lenders face risk. Overestimation is penalized in many cases. The award goes to those who are accurate.

Overestimation has been a technique commonly used by processors. Those that consistently overestimate may appear to have greater costs than competitors thereby giving the illusion of not being competitive. To avoid this pitfall and without accurate up front accurate information, the most common practice was to underestimate. Because table changes or post closing changes were commonplace, underestimation was customary. Not entirely true now. The new rule opines that some costs can be changed at closing but the rule has set tolerance levels mandating the maximum increases permitted.

It is forbidden, in some circumstances, to increase charges prior to the closing which include origination charges and transfer taxes. Charges that can increase, but are subject to the 10% tolerance, include services preselected by the lender, owner's title insurance and government recording charges. Services preselected by the borrower, title fees and initial escrow deposits can change and are not subject to the tolerance. Lenders should be focused on taxes and government recording fees. The reason for heighted scrutiny here is that these charges are the only items with new preset tolerance levels that are not within the control of the lender. This category of charge is also subject to miscalculation thereby providing additional challenges for the lender and title company.

The zero-tolerance mandate concerning tax charges at closing would suggest that they be acquired when the GFE is created, however, electronically obtaining this information in an accurate fashion is extremely difficult for many reasons. To add insult to injury, lenders often must obtain these taxes from different sources such as state, county and local repositories. There are thousands of points of origination for these charges nationwide. Under the new rules, lenders must have instant access to this information in order to comply thereby creating a compliance nightmare which must be dealt with through automation and technology. With respect to recording fees, the 10 % tolerance is challenging as well. Even though recordation costs are customarily less than others, they are usually not susceptible to an exact calculation up front. An estimation is usually necessary. Accordingly, the need for accuracy becomes paramount.

The bottom line is that any tax and recording fees on the HUD in excess of those listed on the GFE taking into account the threshold levels will be the legal responsibility of the lender. Since these charges are payable to others as a third party fee, the lender must systematically maintain a method of tracing the overages, if any, and thereafter make payments on behalf of the borrower. Notwithstanding the legal responsibility of the lender to make these payments, if the borrower remits payment overages, the lender must make reimbursement within 30 days of the closing failing which it will incur the risk of non compliance.

Time to get serious about compliance tools

In order to address this legislation head on, originators must place great emphasis on compliance and ensure that their compliance related tools are integrated seamlessly into their underwriting processes. This focus on compliance driven information technology will necessitate greater spending on software to ensure that loans are processed in a timely but compliant fashion.

The balancing act between effectively implementing compliance technology solutions and managing capital expenditures is a task that faces all members of the mortgage industry. The resolution of this may require a complete re-examination of operating systems. Lenders must take a comprehensive approach to compliance systems to guarantee that all loans are reviewed for compliance prior to post production. Additionally, management must accept the fact that compliance is here to stay and is an investment in the future of their companies. By mid-2010 upper management of major mortgage companies will embrace the importance of compliance however few will have the comfort in knowing that their compliance solutions are safely in place unless they move with deliberation. In order to effectively make the transition, mortgage companies will have to rely upon integrated compliance search engines which will eliminate labor intensive review. There will be expansive changes to underlying operating systems, work flow processes and employees. A corporate culture change with a compliance bias in large lending institutions will likely occur as a by product of the mortgage crisis.

Accordingly the sustainable compliance strategy of many lenders will mandate the integration of an automated compliance search engine. Even though the economic costs will be significant, lenders will reexamine the intrinsic value of compliance, which includes all costs of post close loan document repair, investor kickback and expenses to remediate seemingly benign violations associated with past compliance shortfalls. Considering the risk and cost, the informed decision to execute on an effective compliance program will be an effortless and basic decision.

Specific tools to meet the new GFE challenges

In order to meet the requirements of the new GFE rules, lenders should seek out compliance technology companies that maintain accurate recording fee and tax databases as well as a title premium fee calculator and other tools to ensure accuracy. These solutions should be easily integrated into the operating platform so that the necessary fees can be captured at point of creating the GFE. Due diligence on the provider of choice should demonstrate that it has an internal protocol and allocates employee resources to conduct research on jurisdictions and maintains an internal database of the findings. Finally, the company should maintain a quality control process that consists of checking for any fee increases, decreases or changes in order to keep its database current.

Since lenders have never had to be concerned with up front fees prior to the enactment of the new RESPA laws, it will be a change in corporate philosophy that may take time to accept. Large lenders will be taken by surprise at their general lack of compliance without these new tools. The winds of change are upon the industry. Lenders will be able to navigate these waters by recognizing the issues, maintaining organization and planning, acknowledging the need for corporate change and by immediately seeking the necessary tools to aid in the compliance process. The lender that integrates an accurate, efficient and automated up front fee engine will avoid compliance repercussions that are sure to follow.

The ideal tool is a web based title insurance rate engine that searches the major underwriters and finds the lowest rates available which saves consumers significant money at closing. This software ensures that consumers receive the best product and price while protecting lenders and title agents from claims of overcharging. This new software also provides lenders and title agents with a tool to manage their title insurance orders efficiently.

As lenders and title agents struggle with the new RESPA laws and specifically the GFE tolerances and disclosure requirements, rate engines offer the ideal solution. With accurate upfront title and settlement cost disclosures including title premiums, available discounts, recording fees, mortgage taxes, stamps and more, rate engines allow compliance without disclosure delays.

As stated previously, RESPA compliance presents both lenders and title agents with new challenges. While the change is good for the consumer, it has the potential for a not so good result due to delays caused by inaccurate disclosure or circumstantial changes that require new disclosures and the accompanying waiting periods. In an industry where speed to funding has been paramount to consumer satisfaction, upfront accuracy is more critical then ever before. Now in addition to speed, the industry is rebuilding consumer trust and brand confidence. Small errors or hidden costs can add up to lost days for the consumer and lost profits for both lenders and agents if those errors are simply written off.

In trying to ensure disclosure compliance, many lenders are facing the overwhelming task of trying to manage their disclosures with data from hundreds or even thousands of title and settlement agents where the costs may vary agent to agent. While averaging is an option, it comes with its own set of management and compliance issues. As consumers and regulators examine the costs associated with obtaining financing, lenders and agents scramble for better ways manage the complex world of title and settlement services and costs, especially as lenders shoulder the full responsibility of RESPA compliance including all third party fees as well as their own lender fees.

Rate engines that provide compliance confidence for both lenders and agents by returning a comprehensive list of available title insurance products that match the consumer's specific situation with the premium costs accurately displayed for each product. Often overlooked discounts are displayed giving the loan officer an opportunity to save the consumer hundreds of dollars on title insurance. Additionally, recording fees and other settlement costs provide for a more complete comparison of costs. Selection of product and provider can be made based on best cost to the consumer as well as best of class service providers. Disclosing accurate information upfront in seconds rather than days takes the guess work out of compliance reducing the delays associated with having to re-disclose or pay for it in post production.

In addition to accurate product and premium costs, vendor management software provides lenders and agents a tool to manage the flow of business to their providers. Lenders and agents use this to control the distribution of orders to those providers that meet their service, product, and price requirements. The mystery is removed from the selection process even when the consumer is engaged in that process by providing choices.

For more information on the technology discussed herein, call Mandrien for some advice on rate engines that can help you become compliant.