LOAN REPURCHASES: A PRIMER

Repurchase requests are a fact of life as investors and securitization trustees aggressively monitor loan performance. Before you panic, consider several strategies for making lemonade from lemons.

BY LAIRD MINOR

(Ed. Note: This is the first of a two-part article. Part two will appear in the next issue of Equity Magazine.*)*

Loan repurchases are one of the mortgage industry's dirty little secrets, not discussed in "proper company."

Maybe this is because investors don't like to acknowledge that they sometimes require lenders to take back defective loans, and lenders don't like to admit that they make mistakes. But the simple truth is that repurchases do happen, in the nonprime, FHA, and even conforming sectors, and the prudent lender will be prepared for them.

Every loan sold to an investor is transferred pursuant to a Loan Sale Agreement (LSA), and every LSA contains an extensive list of representations and warranties to protect the investor from material errors and fraud in the origination process.

They cover such things as:

- compliance with applicable laws and regulations;
- accuracy of the data provided;
- enforceability of the note; and
- the existence of a perfected lien.

They also include representations such as the lender's legal existence and its ability to sell the loan free of anyone else's ownership claims, as well as the non-existence of any environmental issues affecting the collateral property.

Warranties against early payment defaults are of increasing importance. Ten years ago, this was generally limited to first payment defaults. Today, nearly every LSA contains a warranty that the borrower will make his first three payments in a timely manner (some contain even longer warranty periods).

This means that if the borrower misses any one of his payments during the warranty period the investor has the legal right to require the lender to repurchase the loan, even if the payment is later made and the loan is brought current.

Repurchase requests are typically triggered by payment default. In some cases a seller's breach may be identified during a routine post-closing audit, but for the most part the file is carefully scrutinized only when a payment is missed. In the current business environment, where investors are competing aggressively for loans and paying high prices, strict enforcement of LSA representations is becoming the norm.

A misrepresentation of income or occupancy status is now likely to result in a repurchase demand.

We are aware of one investor, which has engaged a third party to audit its non-performing loans specifically for the purpose of determining whether there exists any basis for a repurchase demand. It is unlikely that this is an isolated instance, and the practice will undoubtedly spread as investors and securitization trustees aggressively monitor loan performance. Even the GSEs are scrutinizing the quality of their seller/servicers.

We can only expect the incidence of repurchase demands to increase, especially if the economy softens and the rate of defaults rises.

Technically, the repurchase of a loan is no different than its original sale.

Responding to a repurchase demand

One possible response to a repurchase demand is, of course, to ignore the request or refuse to honor the obligation. While a lender is unlikely to resort to legal action over a single loan, this is not the most prudent course of action. Your relationship with that investor will be severely strained, if not ended outright, and your reputation within the industry badly damaged.

Furthermore, most LSAs contain a "right of setoff," so on your next sale to that investor you could find the proceeds reduced by the repurchase price of the defaulted loan. Your warehouse lender might not respond well to that!

A more sensible approach is to request a detailed explanation of the basis for the demand, with a reasonable

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period of time for rebuttal, and to conduct your own review to see if a repurchase is justified. The investor may simply be mistaken as to an issue of fact, and the request withdrawn when the error is rectified. This could be something as simple as a miscalculation of the debt ratio if an income document is missed, or when the investor asserts that the original appraised value was inflated.

Room for negotiation

Any reappraisal or broker price opinion should be timed to the date of the original appraisal, and depending upon the age of the loan that can be problematic.

There may be room for negotiation here, especially if the difference is not that great (most investors regard a 5% to 10% variance as being within tolerance). However, non-performing loans with an original LTV ratio of 100% will be highly scrutinized, as any BPO variance there is meaningful.

If the repurchase demand is justified, the repurchase price will include not only the principal balance of the loan plus any premium originally paid for it, but also any accrued interest due.

This can be significant if some period of time has elapsed between the last payment made by the borrower and the date of repurchase. Often the loan is well into the foreclosure process before the repurchase demand is made (in which case the repurchase price also will include any expenses incurred and advances made by the investor or servicer). Both parties will need to be prepared for an orderly re-transfer of the loan. ■

(Next issue: Examining three issues of critical importance when a loan repurchase must be made.)

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