

Ray Romano Notes

Sep 14, 2010

Intake

We are trying to understand the put back system before the crisis. What is giving Freddie and others the right to do this Contractual “K” or securities?

At Freddie the single family business activity represents approximately \$1.8 T of mortgage debt outstanding as it exists today. We acquire those loans through a series of approved lenders. They sell us loans according to our guide requirements and contractual (“K”) requirements that we may supplement our guide with. In order for the mortgage market to operate efficient we rely on the K relationship between our lenders with the responsibility of reps and warranties that the lenders make to us about the quality of the loans that they are selling to us.

Are those K relationships the same with respect to the R & W's?

Yes

Can we get a copy of that?

Yes, we can get that to you.

Can you distinguish between the automated systems and the big purchase?

We do “F & F” have tools for our lenders to understand the overall credit quality of the loan to our lenders. Lenders can those tools to identify whether the loans meets our criteria. If they do they do get some benefits and some relief. Largely we provide that relief because we are able to replicate a lot of the issues around borrower capacity and credit worthiness. We are to pull in credit report attributes and analyze them and that gives us a good since of the borrower's willingness to repay the debt.

The most important part is to get scale into the business and to be able to serve the broader real estate market. To do this we rely on a delegated business model. We delegate to the lenders the decision to close loans and we will fund those loans provided they make R&W to us as to the quality of those loans and that is all backed by our K's that we have with those lenders. That is a critical part of our business model because we would not reunderwrite the volume of loans coming from all of the customers that we have Ks with.

Once the loans are sold to us, relying on the r & w's, we do a small sample of the loans. It is a statically valid sample on a aggregate basis. We measure, monitor and look at the performance of the loans over the life of the loan. If the loans perform poorly early in their life, the loans get reviewed by the CQ dept to determine if they were properly sold and the appropriate R&W was made at the time the loan was delivered. That cuts down the number of reviews that we are looking at. In an environment in where delinquencies are shooting up obviously our volume is shooting up a lot with it. So if you think about it if the loan defaults in the 1st or 2nd year—we are looking at it. If the loan defaulted in the third year but had payment problems in the 1st and 2nd year—we are looking it. The same goes for 4 and 5 years out.

During a time of house price appreciation is there no need to challenge loans that might violate R & W because you are in a benevolent environment?

The sampling strategy is always at work. There are always loans that are defaulting so we are always looking at loans no matter what. If economic conditions are declining the volume of loans will change, but there are always defaulted loans that are being reviewed, sampled. Based upon this review and sampling we then give feedback to the customers. In the case of the up-front process we are pulling a small sample we are providing lenders feedback with regard to if they are adhering to our K requirements.

Do you do peer groupings so that if you find a counter party where the numbers are not as good as your average, you will not only take care of problems, but also look at other loans from that counter party to see what's going on with them? (12.50)

The upfront due diligence is there to serve two purposes.

1. Identify if there are any lender abortions. (We are identifying the Non-complaint Rate and giving that feedback back to the lender)
2. Looking for high risk credit policies. Policies that we think have some additional risk we want to measure. We are looking at these loans as well trying to figure out if our credit policies are working properly.

Was it your observation that that among your larger seller servicers, Countrywide had a significant worse performance than other loans?

There is no doubt CW loans had a higher incident of non-compliance rate than some other lenders. Over time CW non-compliant rate is higher than our averages.

When did you first notice that?

I don't know the exact date or time period.

What R & Ws are made?

It's fairly broad. The lender has evaluated the loan for compliance with our K requirements and they verified have and have validated the borrowers compliance with policy requirements related to the credit, collateral, and capacity of the borrower and their willingness to pay.

What are the headers?

We are looking at whether the borrower's information was complete, accurate and truthful. We are also looking at whether the supporting documents are complete, accurate and truthful. We also look at credit reports to verify all of the information.

We do find loans that are misrepresented. Borrowers misrepresent the info they supply to the lenders what I would call fraud for home ownership. We also find fraud for profit and those loans go back. The lenders are completely on the hook for a fraudulent transaction that we identify as a part of our K requirement. (19.51)

What percentage of the loans that violate the R &W are fraudulent?
I don't know the number off the top of my head.

What is the percentage of total loans that were put back overtime?

There are a lot of data fields on an application which all need to be substantiated by some document. There are a lot things that can go wrong within a file. When we think about repurchase risk you are looking at potential losses of 3 to 5 basis points. Three is on the high end. It probably is 1 to 3 if you're doing a good job, but it's pretty small.

Loans worth 3-5 basis points of the total you bought would end up getting put back?
Yes, losses.

What percentage or basis points would you put back to the banks?

Based on my experience if I'm doing a really good job = 1 basis point, 3 =mediocre, 5=bad.

In 2001 there was an ongoing process for reviewing loans for put backs. Typically in a given year before the crisis what percentage of loans would be put back before the crisis at Freddie?

I don't know that numbers off the top of my head.

What driving the increase?

One is our compliance with our K requirements. How good were they? That definitely changed as we went through the crisis. Our non-compliance in 08 and 07 was much higher that our previous experience. If you are doing a reasonably good job you would have a non-compliant rate of less than 5%. We were actually seeing rates in 25% range.

We see in the press that \$9B was put back to four banks. So what systems do you have in place to put these things back?

We have a lot more people on staff. Based on our sampling strategy and due diligence strategy we are sampling loans that are resulting in loss producing events, making sure those loans were eligible for delivery to Freddie at the time they are delivered. So if we are taking a loss it is legitimately a loss that we contracted to buy.

When did low buy backs become serious?

As early as 2006 you saw delinquencies. During this period you could see the unemployment rates and the housing prices declining which began to impact borrowers.

When did Freddie Mac tighten its credit standards?

In the 2007 time period.

Was that early or late 07?

Starting in August 2007 we took a posture of no further expansion.

The types of fraud?

1. Borrowers misrepresentation of debt outstanding
2. Income/Occupancy
3. Loan Purpose (Investment versus 2nd home)

When you identify a loan as suspect what do you do?

The process depended on the sample. The biggest sample was the non performing loan sample these are the loans that defaulted. There is also the upfront loan sample. We do some sampling for our charter, predatory lending and high level screening of loan eligibility.

When you are sampling and you get a loan that's non-performing were you going to look at that anyway or would that be one of a number of loans that is likely to be sampled? And what do you do with the rest of them? (36:38)

"It depends on when it defaults. If it defaults within the first two years generally we are going to pull most of everyone of those. If it defaults three years after origination it really depends on how the loans performed in the early part of the cycle. If it reached a 60 day or 90 day delinquency in the early part of its life, I don't care how old it is, it is probably going to get sampled even if the default is three to four years after because it indicates that there could be a problem in the underwriting analysis of that loan. So it gives us the ability to target the resources on the loans that have the highest probability of not meeting our contractual requirements..."

Are you looking at every loan that defaults?

No, we are looking at loans that fall within our sampling strategy.

What percentage of the defaulted loans do you actually review?

I don't know off hand.

If it is a default that occurs in the first two years it's close to 100%?

That correct.

If there is a counter party that is sending you loans that are going bad in years 2 and 3 do you go back and sample more of their defaulted loans?

We might. It would depend.

What about the defaulted loans you haven't sampled do you put any of those back?

No.

To what extent do you have to rely on the courts to solve issues related to your reps and warranties?

Some people lenders have challenged us through the bankruptcy process. Out K have been very tight. We have not had an active lender, to my knowledge, challenge our right to put loans back to them. Not every default is necessarily a violation of their r & w. eg. If someone loses a job.

The process is basically tied to defaults?

It's a system of K, delegation and accountability and we are holding our lenders accountable except when there is suspicion of mortgage fraud.

What has happened historically? How successful has Freddie been in putting back loans to originators?

I'd say we have put requested repurchases back in a much sizable way. We have not always been successful. There are some originators have gone out of business.

You ever fear your actions can cause a bankruptcy?

The seller is not my primary concern. If I find that they are financially weak and and can not make the obligations I am going to take every action I can to protect us. There is a formal of collateral in this called Mortgage Structured Agreements (MSR). The MSRs on these loans are a form of collateral for us. If I believe that the counter party is not going to be able to make us whole for our obligations then I will move to servicing.

Alfred Pollard - [We are crossing also into conservatorship here. We have a policy to actively pursue. We will use conservatorship powers if we have to, but we have not had to.]

What is the magnitude of the loans that were sold that were non-compliant?

The number you see in the paper of \$11B in put backs—that's UPB. So if a borrower defaults on a \$100,000 mortgage you see a \$100,000 loan being put back. The loss to the company is the actual severity of that loan. So if you see an average of 35% severity then you are really talking about a \$35,000 loss to that institution. But I don't know what happens to a loan once it leaves our shop. If everything is working like clockwork it leaves Freddie in the loan form and I get paid back UPB. I don't know what happens to the loan after that.

Is the \$11B in the newspapers UPB or loss?

I think the \$11B is a research report that S&P put out that forecasts what the expected the repurchase rates are still outstanding between Fannie & Freddie based on loss content and not the UPB.

What in terms of UPB has Freddie put pack over the past few years?

No

What is the Order of magnitude for Freddie?

I can get back to you.

How many single family residential loans would Freddie buy in a year?

\$300 Billion worth of loans—a little over a million loans.

Do you see this percentage going up in the next couple of years or are we over the hump?

My expectation is that repurchase rates are starting to decline.

Is there a geographical correlation to this? Does Freddie track that?

Sure. Places like Florida, Nevada, Arizona, and California have stood out. We do see the correlation there.

We talked about fraud and the elements of fraud that you saw how about non-fraud and non compliance?

It's a lot about collateral and valuations issues. It also encompasses lenders failing to calculate income and debt ratios correctly.

How many people are in the CQ dept?

There are 150 people on site, but we also use vendors to perform due diligence for us. We use Advotec and not Clayton.

Another sizable repurchase event is that mortgagers insurers, we see this a lot in this environment, are resending mortgage insurance coverage. If you don't have mortgage insurance you must be repurchased. They are finding R & W issues as well.

Is that happening because the mgt insurers have found fraud?

I would say we find more cases where we don't see any issues with the loans. We think that they are finding minor issues for recessions.

Does that automatically result in a put back?

If a loan does not have mortgage insurance it's a repurchase.

Can you explain the non-compliance in the 25% range?

It's 25% of what we test as opposed to 5% pre-crisis.

The non compliant rate and the default rate were both part of the equation. The default rate was about 50 to 60 basis points and today it's 400. So it was 8X defaults and 5X non-compliance, but we only examined the defaulted. If you did your job perfectly and you get a 100% compliance rate, the default rate could be a 100% and you have no repurchases. But the fact of the matter is that you went from probably an expectable error rate of something less than 5% that went up to 25% and the default rates went up dramatically. That leads to very large volumes of repurchasable debts.

90 plus day delinquencies were running about 60 basis points. Less than 1% cumulative defaulted loans over the life of the loans was a typical event. Agencies Fannie and Freddie's typical life time default rates were running less than 1%. Today they can be running close to ten.

When did you first notice deterioration in the underwriting standards?
In 2007.

No clue before that?

We made it public that the standards were declining between 05 to 07. But the non-compliance rate was probably in the 2007 time period.

What is your explanation for declining UW standards?

I wish I could answer that question. I think the person from Citi said it best, "The music was playing and everyone was dancing." Market share was also probably part of the equation. I can say that if you look at our record we had the best performing portfolio at the worst time. I don't feel great about it, but look at our delinquencies they are the lowest in the industry.