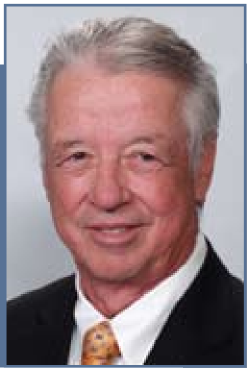
Future Trends - By Roger Gudobba



Risk: Rewards or Not

Everyone experiences some levels of risk in their lifetime, but for mortgage lenders it's a critical part of business.

The Chinese symbol for risk is a combination of danger and opportunity representing the downside and the upside of risk. For example, down here in Florida, driving on the freeway is akin to driving in the Indianapolis 500. We can't begin to anticipate or predict what the other drivers will do. But the difference is that at Indy the professional drivers know what the rest of the field will do in certain situations. There are no surprises. It is even worse on the surface roads. I have seen people go across three lanes or come to a complete stop, put their turn signal on and wait for clearance rather than miss their turn and have to dive past and loop back. That's more risk than reward. Most of us don't know how to react because of lack of experience. It requires more defensive driving down here than anywhere. I believe that if we wanted everyone to drive 70 we should set the speed limit to 55.

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History has shown that physical risk and material reward historically went hand in hand. The risk-taking caveman found food and the risk-averse caveman starved to death. Physical risk and material reward went hand in hand. Until the industrial age activities exposed those involved to physical risk with economic rewards. The advent of financial instruments and markets has allowed us to separate physical from economic risk. A person who buys options on technology stocks can be exposed to significant economic risk without any potential for physical risk, whereas a person who spends the weekend bungee jumping is exposed to significant physical risk with no economic payoff.

What does this have to do with our industry? All types of real property can be, and usually are, secured with a mortgage and bear an interest rate that is supposed to reflect the lender's risk. Mortgage risk is the probability that a lender's actual return will be different than expected. The risk is not only "downside risk" but also "upside risk" (returns that exceed expectations).

Mortgage lenders analyze the likelihood that the funds will be repaid or if they are not repaid, the lender will be able to foreclose and recoup some or all of its original capital. There is also the possibility of losing some or all of the original investment. The charge to the borrower depends upon the credit risk in addition to the interest rate risk.

Going beyond the Perfect Loan led to the Perfect Storm.

For the lender the "Perfect" loan has a 20% down payment, cash reserves, solid collateral and a borrower(s) with a solid employment history, excellent credit and sufficient income to make the monthly payments. While there is always some risk by following these simple guidelines the possibility of a loan going into default is minimized. So what happened?

In a fixed-rate mortgage the interest rate will not change over the life of the loan. Adjustable-rate mortgages transfer part of the interest rate risk to the borrower. As the pool of conventional borrowers diminished, the lenders created new mortgage products. The problem is that many of these unconventional loan products tend to create a higher rate of delinquency and greater chance of default. All of these special financing plans or specialized mortgage products make it easier for

The Chinese Symbol For Risk

the borrower to get the money needed to buy a property. The problem is that it is also easier for the borrower to get into a precarious financial position.

Most borrowers want to make their mortgage loan payments. Unless fraud is involved, the reasons for default generally fall into one of these scenarios. 1) Loss of income caused by job loss, demotion, or the employer down-sizing; 2) One of the co-borrowers no longer contributes financially due to illness, death or divorce; 3) Unexpected medical expenses; and finally 4) Over extended credit use after the loan was granted. The loss to the investor includes principal and interest payments, decreased cash flow and increased collection and foreclosure costs. In addition, the asset may be worth less because of market conditions or the condition of the property.

Unfortunately, borrowers, lenders and investors were caught up in the escalating home prices and relaxed underwriting standards that put many in unsustainable mortgages. This led to the current financial crisis that will take years to get back under control. We are going back to the basics. Rising delinquencies and foreclosures will mean fewer people will qualify for loans. “The pendulum of risk taking by lenders has swung to the side of excessive caution” stated Bernard Baumohl in a recent article. According to a white paper by Benchmark Consulting “Risk-based pricing, in the simplest terms, is alignment of loan pricing with the expected loan risk.”

The complexity and variations in the multitude of loan products offered was overwhelming for both the loan originator and the borrower. Larry Huff from Optimal Blue stated it best “From idea to necessity: product and pricing engine technology has become a necessity in today’s complex lending environment. Underwriting guidelines and rates can no longer be contained on spreadsheets, making technology the way to go.”

He goes on to say “It sounds sacrilegious to say this, but the loan product itself--not the borrower or the collateral-should have the most influence in newer systems because of its complexity and integral relationship with all elements of the manufacturing process. In the final analysis, the mortgage business isn’t going to get simpler. In fact, it is going to get more complicated, and information is going to change even faster as we continue to creatively enhance the variables that influence the risk equation. Yet no matter how complex the rules become, there’s one thing you can count on: The leading competitors in this niche will continue to build systems that can handle the change.”

But is that enough? I believe we need to think outside the box and drastically change the way we evaluate loan applications. Maybe there has been too much reliance on AUS and credit scores. I am not saying these tools have not had an impact on the loan process but we need to challenge the status quo. More on this in future articles.

I recently read a special report Anatomy of Risk Management Practices in the Mortgage Industry: Lessons for the Future published by the Research Institute for Housing America and the Mortgage Bankers Association. This is an excellent analysis of risk management in the mortgage industry I will devote future articles exploring the concepts.

The executive summary is: “Not since the Great Depression has there been a contraction in the U.S. housing market of such scale. With much attention given already to complex mortgage securities, their risks and impacts on financial markets, this study examines the underlying loan manufacturing process that greatly contributed to excessive risk building across portfolios and mortgage securities alike. Particular attention is focused on the dynamics behind risk taking within mortgage firms leading up to the collapse in housing in order to understand what drove these firms to the brink and what lessons can be learned.”

Final Thought: Do you go for the pin and hit your ball across the water hazard or do you play it safe? Remember the bigger the risk; the bigger the reward or the potentially disastrous results. ❖

Roger Gudobba has over 20 years of mortgage experience. He is CEO at PROGRESS in Lending and Chief Strategy Officer at technology vendor Compliance Systems. Roger is an advocate of data standardization and a more data-driven approach to mortgage. Roger can be reached via e-mail at rgudobba@compliancesystems.com.