The Risks We Take

Mortgage originators must understand and mitigate the industry's inherent risks

By **Kevin Parra,** president and CEO, Plaza Home Mortgage Inc.

The mortgage industry continues to face unprecedented risk levels. Credit continues to tighten as a protection against the ongoing fall in home prices, and home prices continue to fall because of tightened credit.

Assessing and managing risk is at the heart of what mortgage originators do. As such, they must understand the risk they take, choose the appropriate level to be competitive and mitigate the assumed risk with all available means.

Brokers assess risk from several viewpoints. One way is with credit standards. These, however, are constantly evaluated and updated to reflect a changing environment.

Property values are another aspect for assessing risk, and they are likely the biggest concern in today's market. This past May, for instance, the Office of Federal Housing Enterprise Oversight House Price Index (HPI) showed that home prices were down 3.1 percent in the first quarter of 2008 compared to the same period in 2007. This was the second quarterly decline following 13 years of increases and the largest drop in the HPI's 17-year history.

Credit and property values affect the increasing default and foreclosure rates, as well. The unprecedented market has demonstrated that borrowers with little equity in their homes, regardless of their credit quality, are much more likely to default on their loans.

According to the Mortgage Bankers Association, the number of Americans in danger of losing their homes to foreclosure grew to the highest level in nearly 30 years during the first quarter of this year. The total inventory of homes in foreclosure increased to 2.47 percent and the delinquency rate — or loans with one or more payments overdue — grew to 6.35 percent. These are the highest levels reported since 1979.

Loans that go into foreclosure not only are a problem for originators because of losses stemming from investors' likely repurchase requests, but they also depress the value of the entire neighborhood. Consequently, originators must avoid making loans at the maximum loan to value in neighborhoods with high foreclosure rates.

Another increasingly problematic risk factor is loan fraud. Now that stated-income loans are virtually nonexistent, unscrupulous mortgage and real estate practitioners are attempting to exploit the current crisis. Fraud was a huge problem in the previous inflated market, but it is an even-greater challenge in the nowdeflated market.

Previously, mortgage fraud was perpetrated to try to get unqualified borrowers into homes they could not actually afford. The hope often was that an anticipated increase in property value would materialize and a quick profit would be realized from selling the property in a rising market.

Today, however, fraud is much more than inflating income on a stated-loan application. It's sophisticated, and the intention is to profit from its victims.

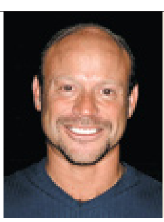
To push back against these challenges, investors and government-sponsored enterprises that purchase loans on the secondary market are performing in-depth evaluations of every loan they purchase.

In the past, these loan reviews often consisted of a cursory, random audit before purchase. Today, however, loans are virtually being underwritten again. Appraisals also are being thoroughly scrutinized before loan purchase.

Additionally, underwriting guidelines change frequently, often with no notice before more-restrictive guidelines are implemented. Any mortgage banker without at least two takeout investors for every loan it offers is therefore taking a risk.

Investors also are increasingly reviewing and auditing all delinquent loans to identify manufacturing defects. They are now adept at recognizing a defect in a delinquent loan and requesting repurchase from the loan's originator.

Only mortgage brokers who produce the highest-quality loans will prevail through the current atmosphere of investors' extreme scrutiny of all loan files.



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