



the Mortgage Press

Keeping The Mortgage Professional Informed

For mortgage lenders—a foreclosure hurricane is coming *What to do before the flooding starts*



By Christopher Brown

Now is the time to plan for a flood of mortgage defaults. All of us know this storm is coming. Some of you are probably already underwater. All of us also know that the lenders will take a great deal of heat, including being criticized for writing some of those loans in the first place. If your institution made mortgage loans during the high-flying, fast-paced mortgage market of the last five years, chances are you know you're about to have your share of bad loans.

For a decade, our firm, Begos Horgan & Brown LLP, has been defending borrowers against foreclosures by banks and other lending institutions. From where I sit, I foresee that borrowers will gain traction in the hurricane of foreclosures lenders are facing. Before the flooding starts, or to keep it at bay, we believe lenders should take a look at their loan portfolios and develop some strategies for dealing with prob-

lem loans. To follow are some suggestions you should keep in mind when developing your strategy.

Lay out tactics for dealing with a higher-than-normal volume of defaults and foreclosures before you need them. The expense of dealing with a few isolated defaults may have been just a cost of doing business before. With the hurricane coming, those expenses may cost you your business. Sooner rather than later, we suggest lenders look at their loans objectively to size up the problem and put together a plan for dealing with a higher magnitude of defaults. Identify the signs of a loan that might become trouble. To do this, sort your loans into "yes," "no," and "maybe" piles by asking yourself if you would make the same loan in today's tighter credit environment. It's important that you not be defensive about your prior lending decisions when you do this. You're only trying to figure out which loans might be problems, not find fault. Be skeptical about the truth of stated income and scrutinize loan-to-value ratios.

Once you have your piles, decide how you will approach the "no" and "maybe" piles. Will you proactively contact the borrowers to see how they are dealing with their adjusted rates? Will you refinance or renegotiate loans for likely-to-default borrowers? How do your capital resources match up to the loans likely to need refinancing or renegotiation? Would selling loans to a speculator at a discount be a better solution? Are you prepared to foreclose? If you are thinking of foreclosure, make sure you have a good handle on the real estate market where the property is located. It's expensive to carry a house, and you may have a lot of them in a bad market.

Look not only at loans in your portfolio but also at your sales on the secondary market. If you sold loans to other institutions, they might be able to come back at you for selling them bad loans. Some lenders might have more to fear from the institutions that bought the loans than from the individual borrowers. The higher the volume of loans you sold to a par-

ticular purchaser, the greater the likelihood of the purchaser having the resources and incentive to claim that your actions hurt their business. It's already happening. Recently, there was a case in Connecticut in which an appellate court upheld a decision entitling the Bank of New York to recover more than \$897,000 from the intermediary who brought Bank of New York two mortgages. The mortgage lender was liable for having negligently, materially and deceptively misrepresented the loans they sold to the Bank of New York. The ruling stated that the intermediary misrepresented the transaction, failed to apply proper underwriting guidelines, violated the lender's criteria and failed to provide accurate information for the closing of the loans. Essentially, the court was saying to the lender, "You made the loan and, when you sold it to us, you misrepresented the details of it. You didn't apply the underwriting criteria you were supposed to and when you sold it, you didn't provide accurate information about the sale."

Evaluate how well your under-

writing guidelines are being enforced. Take a long hard look at your guidelines and figure out how well your underwriters, whether they be in-house or not, are adhering to them. If the guidelines are being properly applied, it should affect the size of your “no” pile. If not, you’ll need to educate your underwriters about the risks of deviating from them.

Take a look at the brokers you work with. Brokers are responsible for bringing in a significant amount of loans. Their practices reflect back on the lenders they represent. You’d be well served to evaluate the accuracy of the information your brokers are reporting to you. After all, you’re making your decisions to lend based upon the information you get from them. Is it worth it to continue a relationship with a broker who’s more anxious to close a loan than to dot the i’s and cross the t’s? Are you giving them your guidelines and are they adhering to them? Would you be better off without them and bringing in borrowers yourself? Would you benefit more from giving the better brokers more financial incentive to match your products to their borrowers? This is a good time for lenders to ask themselves these questions. (If you’re a broker, it’s a good time to ask yourself these questions in reverse to identify lenders you most want to work with and those you might help improve their lending practices.)

Are you matching your loans with the borrowers? When I represent a borrower in trouble, one of the first things I look at is whether the loan made financial sense from the borrower’s perspective. I do

this because courts have been borrowing from other areas of the law and finding that the lender bears at least some responsibility for loans it never should have made. For example, the Connecticut Appellate Court borrowed the doctrine of “unconscionability” from the law of personal property transactions to relieve a borrower from his loan obligation where the loan made sense only for the lender. With record numbers of people in jeopardy of losing their homes to foreclosure, it’s probably just a matter of time before courts are willing to look outside traditional debtor-creditor and foreclosure law to hold the lender accountable for loans that were doomed from the outset. Two concepts from other legal bailiwicks seem particularly ripe. First, the “suitability” rule from securities law prohibits a stockbroker from recommending investments that are not suitable to a client’s investment objectives, needs and risk tolerance. Government agencies have been considering implementing a suitability rule for consumer mortgages. Courts might now be willing to find that a lender is responsible for the fallout from a loan that did not match the borrower’s ability to repay at the time the loan was made. For ARMs, the analysis would be whether the customer currently could afford the loan at what would be the adjusted rate. The “you can always refinance” line many lenders have been using effectively condemns them because it is an admission that the borrower will not be able to make the adjusted payments. Second, the law governing the sale of

goods implies a “warranty of fitness for a particular purpose” into sales transactions. In effect, the seller of a product—in this case, a mortgage—warrants that it’s the right product to meet the customer’s needs. In the mortgage context, an ARM might not be the right product for a prospective borrower looking for a house to live in for 30 years. Why do these arguments have appeal when it’s up to the borrower to decide which loan is best for him? Because mortgage lenders foster the reliance of mortgage borrowers. Courts may just find that such a reliance creates a responsibility on the part of the lender. How many conversations with prospective mortgage borrowers open with, “Let’s see how much house you can afford”? Making a loan after reviewing the borrower’s financial situation creates an implied understanding that the bank determined the borrower can repay the amount loaned. Otherwise the bank wouldn’t make the loan. This is what I call the “you knew better” defense. It goes like this: “You, Mr. Mortgage Broker or Ms. Lender, told my client you needed his financial information to decide whether he could have a loan. You ran a credit check and asked him about income, jobs, bank accounts, brokerage accounts, credit cards and car loans. After gathering all that information about his credit worthiness, you made the loan. My client had every right to believe that you thought he could repay it.” I would not expect no-income verification, low-doc or no-doc loans to be exempt. At least one court has found that the lender

had a duty to inquire about the borrower’s finances if the lender had information that raised a question about the ability to repay. It seems to me that it’s wrong that the bank isn’t held accountable for the understanding of affordability it created. And, although the law hasn’t taken this step, I expect to see it soon.

Why look into new ways of dealing with problem loans now? Because most lenders will acknowledge that, in the throes of the overheated market, they made some loans they probably shouldn’t have. If they try to foreclose on these loans they might prevail, but they can expect that some borrowers won’t go quietly, which can cost time and money in the collection process. Look for some to hire creative attorneys who will claim that the lender should bear the loss because, as between the borrower and the lender, the lender was in a better position at the time of the loan to foresee the default. You don’t want to uncover this kind of a problem as litigation moves forward, when it might be too late to do anything about it.

What does all this mean to lenders? That the current environment is ripe for change and that lenders can expect some heat for riding high over the last 10 years. When it’s over, let’s hope lenders and borrowers are a little wiser and the mortgage market is a lot more rooted in reality.

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