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How To Avoid A Liquidity Crisis By Selling Your Scratch And Dent Loans

If you are not prepared, selling scratch and dent loans can cause an expensive hit to your company's bottom line.

BY CHARLIE HODGE

Mortgage bankers might not like to admit it, but, as with many volume-driven businesses, mistakes, sometimes referred to as "scratch and dent" loans, are bound to occur.

Such mistakes often ultimately prevent the sale of certain loans to your primary investor base. Perhaps your company is moving from broker to banker, and you are new at having to live with what you fund. Or perhaps you're expanding geographically and entering new markets at a frenetic pace, or maybe you're rolling out cutting-edge products with limited time for training and oversight.

HODGE

Aggressive loan officers and upper management are always looking to expand market share and top-line revenue, but often it is at the expense of pushing the envelope a bit too far, resulting in an increased percentage of scratch and dent and nonconforming loans.

The list of issues can range from the somewhat innocuous, such as a missed ratio or guideline requirement, to more serious problems, including first payment defaults, valuation discrepancies or even fraud. Either way, too many mistakes can cripple your liquidity and put you out of business overnight, unless you are prepared to deal with them immediately.

Scratch and dent loans stuck on your warehouse line ultimately translates into money that you cannot lend, resulting in both lost business and the cost to carry the debt. When it comes to your company's liquidity, there should be very little tolerance for indecisiveness.

Planning ahead is critical - especially for smaller players - in order to navigate around any potential liquidity crisis. Developing and maintaining strong relationships with buyers of scratch and dent loans will provide you a second line of defense in protecting your company's precious liquidity.

If well-prepared, you will be less likely to get involved with a poorly funded buyer that can't close the deal in a timely manner or an unscrupulous broker who misrepresents himself as a direct portfolio buyer. Good preparation will result in stronger execution by saving both time and money.

Get to know buyers

Once you have identified a handful of scratch and dent buyers, it is important to get to know them and their individual processes and requirements. This will help you know in advance what information each requires in order for them to bid on your loans accurately, as well as to fund and close the deal quickly.

Essentially, you will need to compile the necessary loan data, often called the "tape," into a format that can be easily distributed and reviewed. Excel spreadsheets work perfectly in this situation.

The tape should include, at a minimum:

- current unpaid principal balance,
- next due date,
- interest rate,
- margin and index (if adjustable),
- lien position,
- type of property (single family, condo, two-to-four family, multifamily, manufactured, mobile home, etc.),
- the property's city and state,
- origination value or updated BPO value,
- if the loan has insurance, such as private mortgage insurance, FHA or other guarantor (include the percentage of coverage), and
- origination or updated FICO score.

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The loan data can also include a 12-month pay history, indicating the number of times the loan was 30, 60 or 90 days past due.

Once the tape has been distributed, you can expect to receive indicative bids from your potential buyers. Often, it helps to set a bid deadline to help facilitate timely execution. An indicative bid is a strong indication of what the potential buyer is willing to pay, based on what was represented, short of a commitment.

It is important to ensure that you send out the same information to everyone, so that you, as the seller, are better able to compare the various indicative prices. Otherwise, you will be comparing apples to oranges, clouding your judgment and potentially impairing the deal's execution.

Once an indicative bid has been verbally accepted, a bid letter is prepared and signed by both parties. The bid letter identifies the pool of loans to be sold and the indicative price. The letter also usually states that you have agreed to allow the buyer the opportunity to be the sole entity that will perform due diligence on the loan or pool of loans over a defined period, usually 30 days or less.

Typical due diligence

For most scratch and dent buyers, due diligence consists of the buyer ordering a broker price opinion (BPO) on the loan, pulling an updated credit report and performing a thorough review of both the origination and servicing files, including pay histories, collections notes, customer correspondence, etc.

Upon completion of the diligence process, the buyer and the seller will review any potential changes to the final price due to the diligence findings. Items such as valuation, pay history or material credit deterioration may play a role in any repricing that may occur.

Again, the more accurate the data is on the original tape, the more accurate the final pricing will be. Once the final price is agreed upon, a funding date can be established and a loan sale agreement can be executed between the two parties.

The loan sale agreement (LSA) is the purchase contract between the buyer and the seller. The agreement serves to protect the two parties immediately after funding and for a defined period of time after the loans have transferred to the buyer.

Depending on the buyer, the LSA will typically set forth these basic concepts:

- the group of loans being sold,
- the price to be paid for the loans,
- the transfer date, and
- a funding schedule outlining transaction details.

Getting the "best" execution on any loan sale transaction is clearly in the eye of the seller. For many companies, best execution may be defined solely as obtaining the highest price. For others, it may be the ability to depend on the buyer's reputation and the commitment to close a transaction with no delays or last minute price reductions.

However, for most companies, the best execution is a combination of price coupled with a high level of service, quick diligence and dependability.

Sellers play an integral role in the overall execution of any scratch and dent deal, as they, in large part, control the speed of the due diligence process. Having well-organized and complete files, before selling the loans, will help to ensure that the transaction will close on time.

Additionally, sellers can greatly enhance their firms' execution and avoid any unnecessary repricing post-diligence by taking the necessary steps upfront to ensure that the initial tape put out for bid accurately represents the pool. Overvalued properties, stale FICO scores and poor pay histories are probably the most critical drivers found to negatively impact price.

Sellers also may find that enhanced execution is achieved through "bulking" their scratch and dent loans. Bulking refers to the practice of grouping loans together in a pool, rather than putting out a single loan for bid. Potential buyers will examine the pool in terms of the weighted average interest rate, the LTVs and the FICO scores. The better loans in the pool provide "lift" to the poorer loans, and, thereby, help increase your overall execution.

If your firm is like most, predicting the number of scratch and dent loans is probably like predicting the yield on the 10-year Treasury two months from now. If you could, you would be in a different business or retired.

Your best strategy, in selling such loans, is to identify the players, develop strong relationships with them and have well-organized, clean loan files that are ready to ship. Having to portfolio too many scratch and dent loans can be a serious drag on your company's profitability, can materially weaken its balance sheet and may unnecessarily utilize your company's liquidity.

Selling scratch and dent loans is clearly not difficult, but, if left unplanned, it can result in an expensive hit to your company's bottom line. SME