



Alvarez & Marsal Approach for Managing Warehouse Lending Operations

Introduction

As record profits in mortgage warehouse lending attract lenders and investors, concern mounts through the lending community regarding new entrants that lack warehouse lending experience. It is important that new entrants as well as seasoned participants understand the controls that must be established relating to common business practices and safety and soundness guidelines that are critical to loss mitigation and profitability in warehouse lending.

Given the fundamental changes that have taken place in the mortgage industry, organizations must demonstrate to management and other relevant stakeholders that their operating model can effectively manage the operational risks associated with their business. In the following piece, we guide you through the Oversight Process, the Credit Approval Process, Risk Assessment and Controls, the Warehouse Loan Management System and the Surveillance Process—followed by our key takeaways for achieving efficiencies as well as some areas in which Alvarez & Marsal (A&M) can help.

Oversight Process



Management should establish a comprehensive framework to confirm that the warehouse lending business is operating within accepted, defined risk tolerances and supports broader corporate objectives.

Program guidelines should be developed and supplemented by written, comprehensive policies and procedures so guidelines are properly interpreted and correctly followed.

Credit Approval Process



The credit review process focuses on the company's management, financial condition, operations, and quality of the underlying collateral to formulate a risk-weighted credit matrix for analyzing the company.

The credit review examines the company's operating structure, depth and experience of the management team, along with current and projected financial performance. An experienced due diligence team (internal personnel and / or members of third-party provider) meets with management to review all aspects of the mortgage company's business.

Upon conclusion of the review and its finding, the lender negotiates a transaction structure with contract and financial term that reflect the operational and financial soundness of the borrower.

Risk Assessment and Controls



Warehouse lenders are exposed to underlying origination risk in the production and sale of mortgage loans. Lender review procedures confirm that the underlying loans comply with investor underwriting guidelines and identify loans that can put the lender “at risk.”

Origination fraud is the primary warehouse lending risk. To mitigate this risk, the lender evaluates the adequacy of the borrower’s origination controls and quality control process to monitor compliance with investor and internal fraud-detection standards. Pre-funding controls then identify ineligible loans and prevent them from being boarded into the funding system.

Warehouse Loan Management System



Warehouse lenders need a loan management information system to control and manage data flow to track and report collateral positions, process funding, settlement transactions, and monitor counterparty activity.

The loan system should monitor a broad array of functions, as multiple funding and settlements occur intraday. The warehouse data management system streamlines these daily functions as well as establishes ongoing processes to support business activity. The loan system is the “data aggregator” and is responsible for producing consistent, complete set of loan-level data used by multiple parties.

A key decision point is whether to buy or build the warehouse loan management system. Warehouse lenders should consider the pros and cons of each option to determine what makes sense for their organization.

Surveillance Process



Risk is dynamic and needs to be continually reevaluated and monitored through a robust surveillance process.

Ongoing credit/risk surveillance processes and vendor management practices tend to be less formalized than the credit review process. But “less formal” does not mean “inadequate.” An inadequate surveillance process can result in gaps in monitoring significant corporate events, expected or unexpected, that may adversely impact the financial or operation condition of the borrower or other counterparties. This process includes any and all third parties involved in the review, monitoring and processing of cash and collateral. Credit, risk and transaction monitoring need to be performed on a regular, systematic basis not just at a point in time.

Lending activities should be monitored by a designated credit officer and risk manager to evaluate the ongoing performance of the borrower and loan facility. Detailed workflows help identify and track process exceptions so that proper internal approvals are obtained.

Key Takeaways

Warehouse lending is a profitable business when operations are efficient and risks are appropriately managed. To achieve the efficiencies, **warehouse lenders should focus on the following key points:**

Establish formal oversight framework to confirm that the business is operating within accepted, defined risk tolerances. Develop program guidelines supplemented by written, comprehensive policies and procedures to ensure guidelines are properly interpreted and correctly followed.

Understand the people, processes and system requirements needed to effectively manage the business and daily operations. Invest in the proper technology and systems to automate functions and provide a stronger control environment. A core information system is critical to managing the flow and dissemination of data and to establishing a sound control framework over lending activities. If the systems and technology infrastructure supporting warehouse lending operations are inadequate, you may fail to identify and control risk.

Secure accurate data to identify, measure, and manage risk. Large transaction volumes and the rapid turnover of loan assets on and off the warehouse line require that daily operational lending activities be performed correctly to maintain control of your data and your business. Operations must be monitored to ensure daily processing activities are performed accurately to ensure data integrity.

Balance the use of qualitative and quantitative techniques to perform an ongoing risk assessment. The increased emphasis on quantitative methods and analytics cannot replace the insight obtained from regular quality control reviews, on-site visits, continuous dialogue with management and staying abreast of market trends.

Mitigate execution risk associated with heavy reliance on the sale of mortgage loans in the secondary market by monitoring processes, counterparties, and market events.

Review internal controls for middle and back office processes where key person risk and inadequate segregation of duties represent genuine concerns. This is of particular importance for warehouse lenders that have small departments or internal operations that rely heavily on several key individuals.

How A&M Can Help

A&M helps warehouse lenders, originators, and servicers identify, assess and control operational, market and counterparty risks inherent in the business in an efficient and cost-effective manner. What sets the A&M team apart is our deep industry knowledge and resources to provide tailored controls and solutions to your organizations unique needs.

Your organization may benefit from the many services we commonly provide to clients, including:

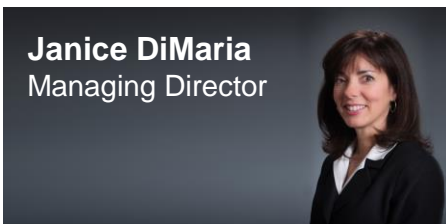
Warehouse lending operational review	Servicer review assessments	Originator reviews	Vendor selection assistance	Model risk management services
<ul style="list-style-type: none">• On site operational review of loan funding and payoffs, pre-funding controls, document review and exception processing, reconciliation reviews and reporting process• Analysis and summary of lending practices compared to leading industry practices, including discussion of control, identified risks, and opportunities for improvement	<ul style="list-style-type: none">• On site operational reviews by servicing professionals performing management interviews, walkthroughs, and control assessment to discuss findings on potential control gaps, risks and areas for improvement• Findings provide fact based information on people, process, and technology relative to industry-leading practices	<ul style="list-style-type: none">• On site operational analysis focusing on loan origination, underwriting, closing, and fraud detection processes, workflows and controls• Analysis and summary of originators practices as compared to leading industry practices, including discussion of gaps, identified risks and opportunities for improvement	<ul style="list-style-type: none">• Design and implementation assistance on vendor selection methodology• Incorporation of functional and technical requirements to create a scorecard that provides an effective assessment of the relative capabilities of each vendor system considered in the selection process	<ul style="list-style-type: none">• Assistance with independent model validations for mortgage prepayment and valuation models• Design and implementation of stress tests

Your A&M Contacts



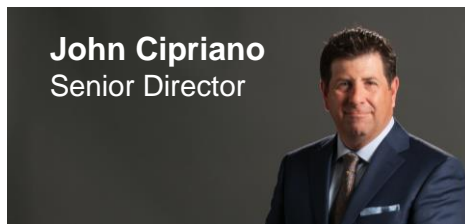
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