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STORY BY // DAVID RASMUSSEN, VEROS EXCLUSIVE TO *DS News*

Scoping Out the Future

Record default and foreclosure rates have placed pressure from all directions upon servicers to reevaluate their traditional default management strategies and practices.

Regulators, communities, consumer activists, and the customers themselves are asking for lower foreclosure rates and investors are pressuring for improved loss frequency and severities. Servicers, faced with depreciating real estate markets, increasing mortgage fraud, and limited default management resources, have turned to risk-based default management (RBDM) as a method to improve the effectiveness of their efforts and manage their resources more efficiently.

The ABCs of RBDM

While a concise and all encompassing definition of RBDM may not exist, at a high level it is an integration of the collections process, loss mitigation, and REO disposition strategies based upon the concept of identifying and quantifying risk through the use of predictive analytics and techniques. While risk identification is not new to servicing, RBDM incorporates new and more objective information into the process through the use of alternative tools, and it promotes the use of "risk recognition" to guide default strategy on individual accounts. Part of this process is market forecasting and various REO valuation and indexing methodologies, as well as other credit and collateral analytics.

As the saying goes, timing is everything. The availability and pricing of the typical tools used allow servicers to access this new and more objective information much earlier in the default timeline than would be the case in a traditional default management strategy. Beneficial to both the lender and the borrower, this earlier and more objective definition and quantification of risk allows the servicer to address its exposure to that risk with the appropriate strategy before its options are limited by market forces, further borrower credit degradation, or contractual limitation.

Additionally, several other factors have contributed to RBDM's increased adoption. Many servicers are questioning the accuracy and apparent bias inherent in some of the tools used to gather information in the traditional default management process. The offset to this is the improvements in

REAL ESTATE MARKET FORECASTING IN **RISK-BASED** DEFAULT MANAGEMENT STRATEGIES IS A **BIG BOON** TO SERVICERS LOOKING TO **UP THEIR SUCCESS RATES** AND **CUT DOWN** ON COSTS

technology and predictive analytics have made these alternative tools more useful and user friendly in the default management function; as a benefit to this ease of use, these alternative tools are easily and inexpensively tested for effectiveness. As if to provide credibility for their use by the servicer, the acceptance of these tools in other areas of the mortgage business to inexpensively identify and mitigate risk has prompted the evaluation of their use in the default management arena.

And the Survey Said ...

In a survey conducted in early 2006 and again in early 2007 by Deloitte & Touche USA, titled "Unleashing the Power," servicers were asked if they were currently utilizing any predictive analytics in their default management processes. Their responses? In early 2006, 36 percent of servicers said they were currently utilizing some form of predictive analytics in their default management operations, while another 36 percent indicated they had plans to do so in the near future. In 2007, however, 58 percent of servicers said they were using some form of predictive analytics, and 21 percent said they were planning to do so soon. This is a dramatic shift in the usage of these alternative tools over a very short time frame and reflects the value-added results of their use to the servicer. Some of the most common tools utilized today by servicers in an RBDM strategy are borrower behavior models, such as Freddie Mac's Early Indicator or credit scores such as FICO, automated valuation models (AVMs), collateral and market risk tools (fraud and early payment default [EPD] predictors), and real estate market forecasting.

The basis of this strategy is the definition and quantification of the risk a servicer faces. Within the RBDM strategy, there is wide latitude for servicers to utilize different predictive tools to accomplish their goals in this regard. Most servicers already have well-established processes in place for quantifying risk, but they add the use of alternative predictive tools within these processes to help them more accurately assess their risk level—and to do so much earlier in the default timeline. Unfortunately, the process of defining risk is where most servicers' traditional default management strategies tend to be lacking in structure and usefulness. This lack of structure and process in defining what is causing the risk associated with individual accounts is a major weakness for many servicers; the nature of the risk associated with an account is what should ultimately be directing the servicer's actions to mitigate that risk.

The Ultimate Benefit

So what does RBDM allow servicers to do? The strategy not only quantifies risk more accurately, but it also establishes the definition of risk on individual accounts to a greater degree and does so in a more timely manner. The benefit of this speed allows the servicer to do a number of things:

- Increase their effectiveness in collections.
- Experience greater loan retention.
- Reduce or inhibit fraud.
- Enhance repurchase review and foreclosure decision-making.
- Streamline REO disposition by directing its resources in ways that will have the most impact and ensuring that the actions taken will have the greatest opportunity for success.

Now, there is no one answer that fits everyone's need, whether in mortgages, auto loans, or risk management. The fact is, every servicer that utilizes an RBDM strategy will have its own methods for managing differing combinations of defined risks at various quantified risk levels. There are many reasons why this is true, but the most obvious is the collateral type and credit makeup of every servicer's portfolio is different so, consequently, their strategies need to be individually focused to accommodate for this fact. Ultimately by necessity there are some similarities among servicers in the way they define the risk they identify within their defaulted portfolios. At the top of the food chain are the four most common risk definitions: credit, collateral, market, and fraud. Within each high-level risk there may also be different risk categories that may require different default management strategies. For example, in dealing with fraud risk, a servicer may opt to approach fraud for housing in a different manner than fraud for profit depending upon multiple factors: the quantified risk level, the contractual options available, the probability of reinstatement, or the viable loss mitigation options available.

Essentially, the basic, core benefit of RBDM is better, more proactive decision-making by the servicer. Servicers that utilize RBDM will make timelier, more accurate, and more profitable decisions. RBDM policies also decrease reputation risk by affording the servicer, and ultimately the borrower, a much higher probability of keeping that borrower in the home under scenarios that are financially realistic for all interested parties.

A Time-Tested Tool

To better understand how RBDM can provide enhanced risk management, let's turn our attention to one predictive tool that servicers have adopted on a widespread basis in recent years: real estate market forecasting. This can be an invaluable tool to mortgage servicers on multiple levels and for multiple purposes. On a basic transactional level, real estate market forecasting can provide a servicer with both a definition of risk for individual accounts and also assist in quantifying the risk level for individual accounts.

As noted earlier, most servicers' traditional default management strategies have well-established processes in place for quantifying the level of risk on individual accounts. These processes typically are predictive and include some form of net present value calculation or equity analysis that represents the effect a property's current value will have on an anticipated loss through various possible default and/or loss mitigation scenarios. There is one obvious limitation to these traditional NPV or equity analysis processes: The scenarios call for liquidation or sale of the property at various future points in time at which the property's value may very likely be different from today's value. Real estate market forecasting allows servicers to incorporate that possibility of value movement in the real estate market for a property into the evaluation of these different default or loss mitigation scenarios. This then allows the servicer to effectively reduce the risk of depreciating real estate values from its decision-making process and allows it to take advantage of appreciating markets.

We all know lenders aren't in the business to own or sell real estate. The upside is, once the lender has taken back a property, real estate market forecasting can be used by servicers to optimize their REO disposition recoveries and shorten their REO timelines. Servicers typically utilize past home sales trends and recent property sales to set REO disposition list pricing. What has become painfully apparent recently to many servicers is that in depreciating markets, this process can leave them chasing markets sometimes significantly down in price and facing extended REO disposition timelines that ultimately result in less-than-ideal REO recoveries. How does a servicer avoid the pitfalls of a "down" market? Real estate market forecasting allows servicers to identify those markets where they will need to be more aggressive in setting REO disposition pricing and to maintain reasonable liquidation time frames, which will ensure the optimization of REO recovery. Conversely, real estate market forecasting can also identify those markets that are either remaining strong or are coming out of their depreciating trend, allowing the servicer to maximize REO recovery by pricing accordingly in those markets.

On a more global level, such forecasting can assist servicers in more accurately estimating their portfolio level default exposure; this can be based upon the aggregate of the estimated REO disposition recoveries of their individual defaulted accounts. The widespread but uneven depreciation of housing prices throughout the United States, along with those remaining still relatively strong housing markets, would support the case of making real estate market forecasting a necessity for any servicer required to make these kinds of default exposure forecasts.

As a final point to this discussion, real estate market forecasting can improve a servicer's ability to forecast the impact of interest rate resets from the potential for default perspective as well as on a per-defaulted account loss severity perspective. This is an area of great concern to many stakeholders across the industry.

Evaluating Real Estate Market Forecasts for Default Management

Beyond the obvious accuracy and past performance of real estate market forecasts, servicers should consider, when evaluating real estate market forecasts for use in a default management environment, how closely does what is being forecast match with their portfolio or individual accounts? Does this forecast mirror the portfolio and lending matrix? Some real estate market forecasts only offer a general forecast for the median-priced, single-family residence in a particular (MSA) or (CBSA). It is apparent, however, that most servicers' portfolios tend to have some concentrations of property types or property value bands, which can also lead to concentrations of properties within particular ZIP codes of an MSA or CBSA.

With the increasing number of news articles, radio shows and television coverage, servicers and even most homeowners understand that within a given metropolitan area there's a wide range in the appreciation or depreciation rates of homes from one neighborhood to the next, or even for one property type over another. Therefore if a servicer is to utilize real estate market forecasting on a transactional level, it should attempt to match the forecast it uses as closely as possible to the property type, property value band, and to the tightest market definition possible.

A forecast needs to push down to the lowest level of servicer need. That level of granularity to include forecasted movement in housing prices as a factor in transactional-level decision-making and for the estimation of portfolio default exposure is available; however, many servicers have not at this point either been aware of this availability or taken them into consideration when choosing a real estate market forecast provider.

Servicers should look for real estate market forecasts that are, and here's a neat word, econometrically based. What this means is the factor that truly establishes the pricing of real estate in any given market is supply and demand, and that factor is not solely affected by what has happened in past real estate market cycles. Supply and demand is affected by a multitude of factors, including, but not limited to, unemployment rates, interest rates, inflation, population trends, available inventory, available buildable land, and to a lesser degree, foreclosure/REO rates.

The Benefit for Servicers

Value and benefit should be the guiding principles in deciding upon a predictive method for servicing. Whether a servicer chooses to implement individual predictive tools into its default management operations or to implement a complete RBDM strategy, there should be a definitive benefit seen by the servicers as a result of that decision. Through the implementation of an RBDM strategy, the benefits a servicer realizes should be lower loss severities, lower direct servicing expenses, lower cost to service, improved loss mitigation performance, improved REO disposition recoveries, lower non-recoverable advances, lower overall servicing advances, and reduced roll rates to delinquency.

Overall, the benefits of an RBDM strategy in servicing provide a win-win outcome for the entire enterprise and help build a well-oiled business engine with a revved-up bottom line. DS