

Sustainable Loan Modifications

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The Obama administration's new loan-modification plan imposes hefty new information-tracking demands on servicers. To make the program work, servicers will need to capture much more data on modified loans and borrowers who get them.

BBy all indications, the extraordinary pace of loan-modification activity that hit new levels last year will continue—and even accelerate—throughout 2009 and probably into next year. The economy is still very much on shaky footing, there is a huge backlog of bad loans in the pipeline and the foreclosure rate continues to be astronomical. ● Now, with the implementation of the Obama administration's Homeowner Affordability and Stability Plan (HASP) and its Home Affordable Modification Program (HMP), the pace will undoubtedly accelerate even more, with new wide-ranging requirements—and incentives—now part of the landscape. ● Any institution that services loans must participate in the HMP for all eligible Fannie Mae portfolio mortgages and mortgage-backed securities (MBS) pool mortgages. While participation in the loan-modification program has been called voluntary, Fannie Mae and Freddie Mac may immediately amend their servicing guidelines to include the administration's loan-modification guidelines, in which case any loan serviced in accordance with Fannie Mae and Freddie Mac standards may have to utilize the proposed guidelines. In fact, even non-government-sponsored enterprise (non-GSE) loans are eligible under HMP. Still, within the structure of the administration's proposed loan-modification program, there is only one opportunity to modify a troubled loan and reap the government-provided incentives.

Unfortunately, much of the significant effort that has been expended to rework nonperforming loans has been futile in more than 50 percent of the cases, according to LPS Applied Analytics, San Diego. That means overtaxed servicers must continue to manage the barrage of distressed borrowers seeking first-time modifications, while monitoring the status of loans that have already been modified so they can tackle new problems as they arise.

To be effective, servicing organizations must be able to track and take action on modified loans based on a comprehensive view of loan-modification details. Further, they must manage those details over time in order to fully leverage the modeling tools that can help them proactively identify loans at risk for recidivism. Ultimately, servicers must be able to track every detail of a loan modification throughout the course of its term.

The fact is, no matter what an organization's analytics and risk models are, or how accurate and robust they may be, without access to the right data at the right time, those models only tell part of the story. As a result, hidden risk remains.

The challenge of change

Certainly, there has been a tremendous amount of change—and perhaps more to come—with regard to loan modifications. Fannie Mae, Freddie Mac and the Federal Housing Administration's (FHA's) HOPE for Homeowners [H4H] program have all introduced modification programs to help servicers get more modifications done. HMP, launched in March 2009, is just now beginning to filter through the industry.

Yet, the failure rate on loan modifications has been so high that questions continue to be raised about whether or not they are effective. Of course, for some borrowers, loan modifications provide the necessary "shot in the arm" that can help them stay in their homes. But for many others, a loan modification is simply not enough to keep them on track over the long term.

Why have borrowers who are unable to sustain a mortgage loan been approved for these loan modifications? Frankly, it has been exceedingly difficult for the majority of servicers to determine which borrowers are at risk of sliding into delinquency again. There are two main reasons for this.

The first reason, of course, is that we are still in uncharted territory. Many of the loan modifications currently on the books were closed within the past six months and it may well be months more before servicers learn whether or not these borrowers will adhere to their new terms. Without a much deeper view into each borrower's unique circumstances, the financial institution simply has to wait and see what happens.

The second—and more troubling—reason is that the vast majority of servicing systems don't capture the

appropriate data to properly track and measure the effectiveness of modifications. There are a large number of distinct data elements that must be captured to properly gauge modification sustainability, and most servicers have only limited access to the full range of information they need.

But it goes further than that.

These same data are also critical to the organization's ability to work through modifications that have failed, and determine what went wrong and whether a more sustainable solution exists for borrowers. This analysis is important in determining which borrowers will get another chance at a modification, as well as those who are eligible for their first modification. Certainly, the hope is always that more families will be able to stay in their homes and meet their mortgage obligations.

A wealth of data

There are five specific data areas that servicers must capture in order to proactively track modified loans and respond to warning signals if borrowers begin to struggle. The first is accounting data—the borrower's comprehensive financial picture, how much money he or she is able to pay, the length of the new loan term and how much debt is deferred or forgiven.

Secondly, there are pre- and post-modification data. The servicer must track the interest before and after the modification, the calculated difference between the two and how much interest on the debt was forgiven (or deferred) in the shift. It must also track the loan-to-value (LTV) and debt-to-income (DTI) ratios, both pre- and post-modification.

Another pre- and post-modification data area is specific to adjustable-rate mortgage (ARM) loans. A good deal of

these data may not come into play immediately, but certainly will at the point of reset. For example, if the servicer changes the floors or caps on an ARM loan now, it may not have an immediate impact on the institution—but it is important to capture the information because of the probable future impact to the company.

Next is the area of common data, which is not specific to the first two areas. These data include what types of loan modifications the organization has already done, as well as new modifications under the HMP initiative, and the closing dates of individual modifications. Lenders should be able to associate the date of a modification to all of the other data on the servicing system. Then, ongoing analysis is as simple as keying in a particular date to see all of the information associated with a loan before, during and after a modification.

Lastly, it is critical to track the status of modified loans from start to finish. Servicers must be able to monitor the performance of modified loans regardless of the specific terms of those loans, to proactively identify and communicate with borrowers who may be headed for trouble

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again—and to conduct the necessary reporting to obtain available incentives.

Servicers must also track the financial implications of loan modifications for regulators, investors and shareholders. It is also useful to compare and contrast the way various types of modifications perform—whether for agency or non-agency loans. Tracking at every stage of a modification effort helps organizations better anticipate fluctuations in their financial picture and to plan their resource needs for foreclosure and real estate-owned (REO) initiatives.

The greatest challenge for servicers moving forward continues to be the inability to readily access all data about loans that have been modified, including information about the previous loan and the factors that were changed on the modified loan. However, when these data are accessible, servicers can use them to closely monitor all modified loans to better manage their portfolios while meeting all regulatory and investor requirements.

Tracking deferred balances

Nearly all modification programs offer deferred balances as part of the workout. By determining the borrower's debt-to-income ratio, lenders back into the most appropriate and manageable payment for an individual borrower. There are also several escalating options, depending on the DTI ratio. For example, the lender may reduce the interest rate, which is most common at this point; extend the term of the loan; or defer a portion of the principal balance for some period of time.

Servicing systems must be able to track the amount of the deferred balance, even while the borrower continues to pay on the reduced principal balance. When the borrower sells the property or gets ready to pay off the modified loan balance, the deferred balance must be added back in for payment. Clearly, if the servicing system cannot track the information—particularly if the loan moves from one company to another—those deferred funds may not be associated with the modified loan and can be lost forever.

The financial institution also needs data in order for ongoing default and management information reporting to be accurate. Both the deferred and the current principal balance may need to be included in such reporting. And obviously, tracking deferred balance data is critical should the modification fail. If so, that balance must be included in any foreclosure proceedings.

Even if the modification takes hold and is successful, the servicer still can't lose sight of deferred balance data, regardless of how well the actual balance is being tracked. If the information is not properly accounted for, the financial institution can lose the ability to collect the deferred funds, though the servicer will still have to report on a combination of both balances. Unfortunately, most servicing systems lack the ability to track deferred balances alongside actual balances.

Impact of HMP on servicing

Of course, the HMP brings a whole new selection of data to be tracked, analyzed, acted and reported upon. If a borrower meets the qualifications for a modification as set forth by the program, then there are a series of stages that must be tracked—some with data elements quite foreign to normal servicing requirements.

At the heart of the HMP is the trial period allotted to borrowers, under which the servicer will first determine eligibility and then move into a series of cascading analyses to create a new payment plan that includes a calculation of anticipated escrow, and is based upon the acceptable debt-to-income ratio (marked at 31 percent on housing) according to the HMP. In order to do so, the servicer must begin by determining a new balance by waiving any late charges and capitalizing any corporate advances and past-due interest.

From there, the next step is to reduce the interest rate, currently set at a floor of 2 percent. If the interest rate is reduced to the floor and debt-to-income is still higher than 31 percent, the servicer can begin to extend the term up to 40 years from the modification date. If, after all that, the debt-to-income ratio is still higher than 31 percent, the servicer must begin to defer principal.

Borrowers who are already delinquent before their HMP trial payment plan is in place will have a 90-day trial period with the new terms. While servicers cannot solicit homeowners who are not delinquent, if borrowers contact them and can prove that imminent default is likely (often due to job loss), that loan may also be eligible for HMP and will have a 120-day trial period.

If borrowers make three consecutive payments within their specified trial period, the loan can then be officially modified to the new terms. At the very

least, the servicer will need to begin tracking the status of the new loan terms immediately and the borrower's continued ability to meet them over time.

Borrower-status tracking

Multiple borrower status levels must be tracked, including the borrower's state prior to the modification trial period, and the borrower's performance in meeting the terms of the new payment plan.

Should the borrower redefault after the trial period, that loan becomes ineligible for further modification under HMP. Therefore, the servicer must track the fact that the loan has been modified under HMP so efforts won't be made to try to modify that same loan under the program sometime down the road.

Since Fannie Mae is the financial agent for the United States (as designated by the Treasury), servicers that want to participate in the program for non-Fannie loans must execute a servicer participation agreement and related documents with Fannie. They must also be able to report HMP-required information to the GSE on all loans that fall under

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the guidelines of the program—not just those held or guaranteed by Fannie itself. The servicer must report delinquency status on all loans in a portfolio, so as to determine whatever incentives there may be for both borrower and servicer.

Borrowers who stay current on the terms of a modification under HMP are eligible for up to \$1,000 annual principal reductions over five years. In order to report this information, servicers must track the delinquency status each month, report it to Fannie Mae (since Fannie is the appointed financial agent for the United States) and accrue the incentive amount in the servicing system. That way, the servicer knows each loan's modification anniversary date and when to expect a disbursement from Fannie to reduce the principal balance of a compliant loan.

Adding an extra twist to the tracking requirements, borrowers will not lose HMP eligibility until they are 90 days delinquent—but the level of delinquency reduces the borrower's HMP incentive correspondingly. Throughout the course of every month, the servicer must be able to track status incrementally to determine how much of the annual payment the borrower is actually entitled to.

A clearer picture

There will be a great deal more data servicers will need to track under HMP. Default and delinquency reporting will continue to be important, but rather than reporting to the investor, the servicer will need to find some way to report on HMP status. All loans that are participating in the program—which could cover multiple investors—must be reported to Fannie Mae throughout the life of the loan.

Another addition to the servicer's data-tracking responsibilities under HMP relates to debt-to-income ratios. As mentioned earlier, currently housing DTI—front-end income—needs to reach 31 percent. But the servicer must also track back-end, or overall DTI. Should the back-end DTI ratio surpass 55 percent, HMP requires the servicer to refer the borrower for credit counseling. Obviously, this requires expanding the level of data captured, tracked and analyzed far beyond what servicing systems have traditionally done.

This is for the best, though, because if front-end debt-to-income is the only criteria examined during modification, the picture is, at best, only half-clear. This is one of the main reasons why so many modified loans fall back into delinquency and default post-modification. Without taking into account the borrower's other debt (automotive, credit card, and so on), there is really no objective way to ascertain whether even the new, modified terms will be workable.

One thing is certain: With HMP requiring all modifications to be completed by the end of 2012, servicers need to be prepared for a marked and continued increase in HMP-related activity, along with all of the associated new data that will be required. Loans, to be eligible, must have been

originated before Jan. 1, 2009, and the program will continue to operate through Dec. 31, 2012. New borrowers could be added until that very last day, meaning that incentives will continue to be paid through 2017. A borrower not even technically delinquent right now could become eligible even two or three years from now.

With even non-GSE loans eligible to participate in HMP, given investor approval, servicers also need to track against non-agency paper. In order for non-GSE loans to become eligible, servicers must sign agreements to participate in the program.

In addition, the servicer is required to service all eligible loans pursuant to the guidelines “unless explicitly prohibited by contract.” Servicers must review all of their servicing agreements with investors and validate with each one

whether or not the investor will allow modifications. For those that will not, the servicing organization must reach out to the investors individually and secure clearance to modify loans under HMP. Given the pressure the government will place on servicers to do so, and the incentives involved, there will most likely be a push in this direction in the coming months.

Proactive risk management

To lower their risk exposure and prevent further foreclosures from occurring, servicers must find ways of tracking modified loan information. They need easy and comprehensive access to all modification-related data throughout the loan term.

These data will allow the organization to reach out to borrowers already in modified loans, but who appear to be having difficulty even with the new terms. There are proactive risk-management capabilities available today that can examine bor-

rower behavior from all angles—mortgage, home-equity, automotive and credit-card loans—and identify borrowers who may be in trouble prior to any sign of delinquency.

With a newly modified loan, a 360-degree view of the customer becomes even more desirable, because other credit burdens and delinquencies are often precursors to the borrower falling behind on the mortgage. In today's economic environment, it's simply not enough to look at individual loans in a vacuum.

Access to data, granular-level loan-modification tracking and keeping a sharp eye on the borrower's financial situation are essential for servicers, regardless of how assistance programs may change over time. Not only will this approach help ease the loan-modification process, but it will help reduce the organization's overall portfolio risk, while allowing servicers to take full advantage of HMP incentives. **MB**

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