Loan Modifications— *At the Forefront*

BY JASON R. MARX

The growing demand for loan modifications cries out for a systematic response that incorporates efficiencies and best practices.

Many mortgage industry executives and industry analysts believe that the current mortgage crisis is so serious that only systemic changes can stop further losses from escalation. But not everyone agrees with the new programs being developed to achieve this or the results of the current loss-mitigation options available to lenders and borrowers. Critics of current programs have argued that large-scale loan modifications could produce high rates of recidivism and simply push problems further down the road rather than solving them, as homeowners with hastily modified loans may find that they cannot afford even the extended terms and lowered rates. ● Whether prevention initiatives such as the Federal Housing Administration's (FHA's) new HOPE for Homeowners (H4H) program will be successful remains uncertain. The program is intended to provide relief to as many as 400,000 distressed borrowers. However, recent program changes intended to reduce the program costs for lenders and borrowers by increasing allowable loan-to-value (LTV) ratios and simplifying the process to remove subordinate liens should encourage lenders to take a fresh look at participation in the program. ● In any event, it is clear servicers and lenders need to develop comprehensive loss-mitigation programs for the borrowers who will not qualify for

REPRINTED WITH PERMISSION FROM THE MORTGAGE BANKERS ASSOCIATION (MBA)

these targeted refinance programs. Such loss-mitigation programs will need to efficiently segment borrowers and provide the right loss-mitigation solution for them, whether it be a refinance, loan modification or other loss-mitigation measure including foreclosure.

Loan modifications as a first-line tool

With many servicers, lenders and investors ill-equipped to handle growing inventories of foreclosed properties, it is clear that foreclosure is a worst-case scenario for both borrower and lender. Besides displacing a homeowner, a foreclosure can result in up to $80,000 in losses for the servicer or lender, loss of tax revenue for local and state governments, and lower property values for neighboring homeowners.

To avoid the lengthy and expensive foreclosure process, servicers, lenders and investors may now be more willing to accept interest-rate reductions earlier in the default process. This has made loan modifications a more palatable solution for both groups. Servicers and lenders are now looking to loan modifications as a first-line tool to provide relief to troubled borrowers.

Recently, the Federal Deposit Insurance Corporation (FDIC) announced a systematic loan-modification program for troubled residential borrowers who have their mortgages owned or serviced by Indymac Federal Bank, Pasadena, California. The program is intended to reduce future defaults in the portfolio by providing borrowers with more affordable payments through a combination of interest-rate reductions, extended repayment terms and principal deferrals to bring mortgage payments down to a maximum of 38 percent debt-to-income (DTI) ratio.

With loan modifications taking on a more significant role in loss mitigation, servicers and lenders need to develop a comprehensive loan-modification strategy to expedite help to homeowners. Implementing these workflow processes can be a Herculean effort for servicers and lenders already strapped by limited resources. Add in skyrocketing volumes of potential modifications and the fact that, to this point, there has been no standardized approach to modifications to model a successful program after, and one can see why servicers' and lenders' anxiety has grown.

With loan modifications taking on a more significant role in loss mitigation, servicers and lenders need to develop a comprehensive loan-modification strategy to expedite help to homeowners.

Developing and executing a comprehensive strategy is critical to ensuring the efficient, consistent and accurate execution of the high volumes of loan modifications facing servicers today. In addition, with the rapid and continuing influx of new legislative and regulatory guidelines, servicers must be able to rapidly respond to any forthcoming requirements.

Overall, the following considerations should be included in the implementation of a loan-modification program:

■ *Investor requirements*

Have a clear understanding of your contractual obligations to investors. If you are working with multiple investors, include their requirements as criteria for borrower segmentation.

■ *Borrower segmentation*

Develop clear and definitive criteria for borrower segmentation, taking into consideration FICO® scores, DTI and LTV ratios, and payment affordability.

■ *Resource assessment*

Evaluate the internal staffing resources that are available to you, including their strengths and weaknesses. Can you implement quick development programs such as borrower-interaction training to make your resources more productive? Can resources be reallocated from other parts of the business where capacity may be more balanced?

■ *Workflow analysis*

Understand your current workflow. Where are your resources devoting most of their time in the loan-modification process? What are the workflow bottlenecks in the process that limit your ability to reach more borrowers faster? Is it the segmentation and review process, or document delivery and confirmation? Identify administrative and processing functions that pull resources away from borrower interaction, and research methods to automate those functions.

■ *Compliance capabilities*

What resources are available to monitor changes in regulatory and investor requirements? Do you have the capabilities to quickly implement changes once identified?

■ *Content requirements*

Clearly define the types of loan-modification agreements you want to provide to your borrowers as well as any supporting or trailing documents. Will you support both fixed-rate and adjustable-rate modifications? Will there be step-up provisions or extended loan terms? Will you record all agreements?

In theory, the model for a successful loan modification looks fairly simple. However, servicers and lenders today are operating with limited resources, and most do not have the processes and/or resources in place to support such a program. Therefore, developing a best-practices approach in conjunction with outsourcing can be the most efficient way to get a loan-modification program up and running quickly.

Developing a best-practices approach

For loan modifications to be successful as a loss-mitigation tool, there must be a scalable and repeatable process in place that can be customized to meet each borrower's needs. What are the key considerations for a best-practices approach to loan modifications?

1. Proactively segment borrowers and establish criteria for each group

While there are industry guidelines for borrower segmentation

based on FICO scores, payment history, LTV and DTI ratios, it is important to determine the criteria that meets a servicer's or lender's specific business needs.

The American Securitization Forum (ASF), New York, recommends grouping borrowers into four segmentation areas, including borrowers who qualify for a refinance; borrowers who qualify for a fast-track loan modification; borrowers who require additional due diligence before putting together a loan modification; and borrowers whose loans cannot be modified and for whom other loss-mitigation tools must be explored.

2. Offer the best loss-mitigation solution to meet the borrower's needs

With clear borrower segmentation, servicers and lenders can more quickly provide borrowers with the appropriate solution. By fast-tracking the borrowers whose issues can be addressed more quickly, resources are freed up to work with borrowers whose loan situations are more complicated.

A solid base of loan-modification variations include shifting to a fixed-interest rate, extending the loan term or extending the fixed-rate period of an adjustable-rate mortgage (ARM). In addition, capitalizing arrears as a balloon payment is becoming more common.

3. Execute the loan modification in a timely manner

For those borrowers meeting the fast-track criteria, servicers and lenders should develop streamlined processes that enable them to efficiently execute the loan modification with minimal due diligence. Servicers and lenders should take time to identify any obstacles in their established workflow processes, and develop and implement methods to streamline those processes. In particular, they should identify and eliminate any administrative or manual processes that pull resources from borrower interaction. For instance, are your resources being used to re-enter data and assemble packages for overnight delivery to borrowers? If so, outsourcing these tasks would allow staff to more effectively focus efforts on revenue-generating activities with customers instead.

Most servicers and lenders are not using their available resources to their fullest potential, because much of the loan-modification work is done manually and is very labor-intensive. In this case, it might be beneficial for servicers and lenders to consider a more automated approach integrating the data requirements for completing the document package for loan modifications and delivering them electronically. This would then help shift the focus back to the borrower's imminent needs as well as decrease the time and expense it takes to complete the fulfillment process.

4. Provide consistent, accurate documentation

In November 2008, the Federal Housing Finance Agency (FHFA) urged servicers to adopt the new Streamlined Modification Program (SMP) set forth by Fannie Mae and Freddie Mac as the accepted standard for identifying borrowers who could be helped in preventing avoidable foreclosures. SMP targets owner-occupied properties where the homeowner has missed three or more payments and creates a standard definition of new payment affordability at 38 percent of the borrower's monthly gross income. While each borrower solution may vary and servicers will have flexibility in modifying loans, consistent documentation better supports systematic implementation and auditing efforts. In particular, those borrowers who require additional due diligence and more comprehensive documentation—such as credit disclosures, tax-record request forms and income verification—require additional workflow steps that can accommodate the delivery and receipt of borrower information.

5. Quickly implement new regulatory and investor requirements

Driven by intensified regulatory, consumer and investor scrutiny, and the speed with which new legislation can be enacted, servicers and lenders must be prepared to implement compliance updates quickly. Developing a best-practices approach to providing accurate, compliant loan-modification agreements and supporting documentation requires assessment of your compliance and content change-management capabilities. In today's environment, most servicers and lenders are recording their loan modifications, so accurate documentation also means meeting recording requirements for all jurisdictions.

Driven by intensified regulatory, consumer and investor scrutiny, and the speed with which new legislation can be enacted, servicers and lenders must be prepared to implement compliance updates quickly.

Loan modifications as a retention tool

Smart servicers and lenders are taking an even more proactive approach and utilizing loan modifications as an early-intervention and customer-retention tool. Through proactive borrower segmentation, they identify ARM loans that are scheduled to reset in 90 to 120 days. If the borrower meets predefined criteria, then a fast-tracked loan-modification solution is offered. If the borrower is current on his or her contractual payments but has an increased probability to go into default based on the size of the new payment at reset, the loan-modification solution may be used to proactively provide the borrower with the terms that could have been obtained through refinance, and mitigate the potential for future delinquency.

In such cases, the servicer or lender wins by retaining performing loans. If the borrower profile indicates inability to pay at the reset amount, then the loan modification puts the borrower in a more affordable loan without the additional costs of waiting until the default process has begun.

The advantages of outsourcing

In today's challenging environment, most servicers and lenders don't have the budget or the time to ramp up

resources or invest in technology to improve workflow processes. They are under pressure to quickly implement their loan-modification programs with limited resources utilizing manual, non-systemized processes not designed for these business conditions. This exposes the servicer or lender to multiple failure points, inefficient utilization of resources and the inability to produce consistent, accurate and repeatable solutions.

Given these constraints and the growing backlog of loans requiring intervention, outsourcing some or all loan-modification functions becomes a more attractive option. As this market phenomenon continues, there are more companies offering specialized outsourcing services—from a full, outsourced option to automation of specific functions.

Loan-modification document preparation and delivery are resource-intensive administrative functions where outsourcing can provide significant benefits. It can free up resources so that servicers can focus on borrower intervention, as well as streamline processes that will reduce turn times from several days to several hours. In addition, a qualified outsourcing partner will ensure that your documentation is consistent, accurate and compliant, relieving you of ongoing compliance-maintenance worries.

For example, one large servicer based in the southern United States recently turned to outsourcing to help it begin modifying several thousand loans per month almost immediately. Through outsourcing, the servicer was quickly and easily able to set up a complete library of modification documents compliant with investor requirements, and through the use of an automated document-preparation and eDelivery solution, rapidly began executing modifications with distressed borrowers. Outsourcing proved a workable solution for this servicer, as it was able to begin helping borrowers stay in their homes and retain more of its revenue nearly instantaneously.

Loan modifications are not the panacea for the current wave of troubled mortgages; however, they can play a critical role in the overall solution.

When considering a provider for loan-modification document preparation and delivery solutions, these are some factors to evaluate:

■ *Rapid implementation capabilities*

Look for a partner that can quickly implement its solutions. Does it offer standardized loan-modification agreements, as well as supporting package documentation? Does the partner have multiple options for data exchange? Does it offer direct data input or integrations with key loan origination system (LOS) and servicing applications? Can it offer silent integrations? Can it integrate with other service providers?

■ *Comprehensive solutions*

Look for a partner that can provide comprehensive solutions. Can it provide resources for data input to help reduce backlogs? Does it support multiple types of modification agreements and packages? Does its content meet recording requirements for all jurisdictions? Does it offer multiple delivery options?

■ *Compliance and content-management expertise*

Look for a partner that can rapidly set up compliant loan-modification agreements, as well as quickly implement any forthcoming regulatory or investor requirements. Will the partner stand behind its compliance content with a strong warranty and industry reputation?

■ *Secure delivery capabilities*

Look for a partner that can readily support secure delivery of your agreements and packages. Does the partner offer secure, bi-directional delivery with eConsent and eSignature capabilities? Does it offer automated mail fulfillment if the borrower does not accept eDelivery? Can it provide delivery audit reports? How easily can its delivery functions be set up?

By partnering with a capable loan-modification document preparation and delivery provider, servicers and lenders can implement their loan-modification programs rapidly and with the confidence that each transaction meets their specific business and workflow needs. Furthermore, borrowers can be confident that their loan modification is being handled quickly and efficiently.

Out of adversity comes opportunity

It's no secret that the mortgage industry has changed radically and rapidly over the past few years. Although few anticipated the challenges that have impacted the marketplace, the manner in which lawmakers, regulators, servicers, lenders, investors and borrowers respond to this crisis will shape the future of the industry.

Loan modifications are not the panacea for the current wave of troubled mortgages; however, they can play a critical role in the overall solution. Through loan modifications, servicers and lenders have the opportunity to reduce their losses and maintain revenue streams while giving borrowers the opportunity to remain in their homes.

By developing a best-practices approach to loan modifications and, in some cases, turning to industry partners to help with efficient implementation, servicers and lenders can effectively take advantage of this important loss-mitigation tool. In doing so, they'll take another step toward financial recovery in these challenging times. **MB**

Jason R. Marx is vice president and general manager, mortgage, for Wolters Kluwer Financial Services, Minneapolis, a leading provider of regulatory compliance solutions to the mortgage industry. He can be reached at jason.marx@wolterskluwer.com.