

Getting to Know Borrowers Again

Who Pays, Who Delays and Who Strays

by **Larry Cordell and Jericho Trianna**

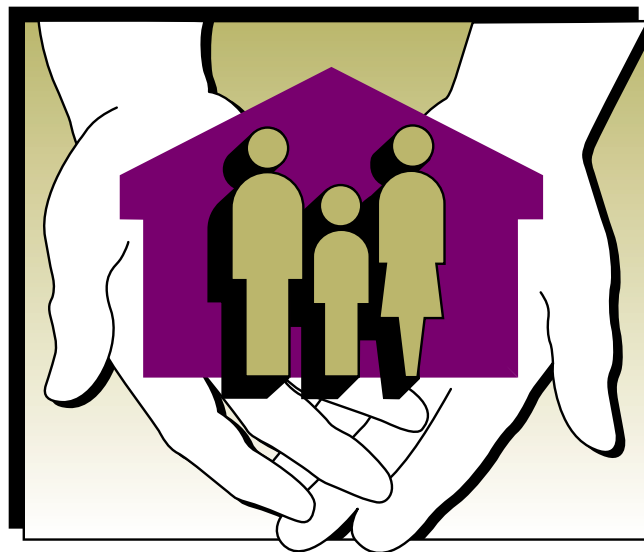
WHEN A MORTGAGE PAYMENT fails to arrive on time, a loan **servicer** must find out why and then determine how to resolve the matter if a check is unlikely to arrive soon.

That was an easier task 30 years ago when banking was conducted between neighbors. Lenders and borrowers used first names, swapped stories, sent their children to the same schools and shopped at the same stores. It was a time when dropping by the lender's office was customary and lasting relationships were common.

When someone faced financial adversity in those days, the lender often was aware of the family's bind even before the first mortgage payment was missed. That kind of personal rapport allowed a lender to pursue a solution before the borrower became seriously **delinquent** and spared the lender the necessity of mounting a formal **collections** campaign to recover the **arrearages**.

These days, many mortgage-servicing operations administer

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hundreds of thousands of mortgages on homes throughout the country and could not do so without computerizing the process. Although labor-saving technology is effective and cost efficient, automation lacks sensitivity.

Making Everyone Happy Requires Deft Touch

Some borrowers with short-term problems may take offense if treated as chronically late-paying borrowers. Others with more serious problems might not receive the intensive early attention crucial to averting loan default and loss of their homes.

Now, however, new account-management technology promises to restore some of the personal touch to the mortgage business. Behavioral-scoring systems, such as Freddie Mac's EarlyIndicatorSM, deliver the cost savings expected of technological innovation while enabling large servicing companies to connect with individual borrowers when necessary but on a more personal level.

Scoring systems for delinquent-loan behavior were developed by the credit-card industry in the 1980s. The technology went largely unexplored by the mortgage-servicing business until 1996

when Freddie Mac first released EarlyIndicator.

Like any conscientious mortgage investor, Freddie Mac wants to keep owners in their homes, but sometimes problems arise. EarlyIndicator is but one way the company works to help late-payers bring their loans current and hold on to their properties.

EarlyIndicator predicts the repayment behavior of borrowers who fall behind by one or more payments. The computer program generates two sets of numerical scores. The first helps servicers prioritize collection-calling caseloads while the second formulates the best [loss-mitigation](#) alternative under the circumstances:

- The collections model analyzes the expected behavior of borrowers when they first fall behind, typically starting with the official [due date](#)—quite often the first of the month. Other times, the model begins with the expiration of an optional [grace period](#)—typically no later than the 15th of the month. The analysis runs through the last day of the month in which the payment is due. The model stratifies accounts into distinct pay-habit patterns to help servicers tailor an appropriate approach to the borrower.
- The loss-mitigation model takes over where the collections model leaves off, rescoring loans now due for two or more payments to determine which borrowers are most likely to lose their homes.

Most late payments manage to arrive by month's end. EarlyIndicator lets servicers single out and provide extra attention to those most likely to remain delinquent.

Surrendering the Shotgun

Before the advent of scoring, servicers frequently resorted to a shotgun approach to bring delinquent accounts current. The drill involved throwing as many loan collectors as possible at the problem. The collections agents, often equipped with [auto-dialers](#), made at least one attempt to collect on each delinquent account per investor timelines.

The bulk of tardy payments, however, come in on their own by month's end, making the shotgun method wildly inefficient. EarlyIndicator lets servicers single out the small minority that are likely to remain delinquent and therefore need extra attention. Consequently, servicers can focus collections efforts where they will do the most good without jumping the gun.

While EarlyIndicator can provide insight into late-payer

behavior, a servicer still must decide what to do next. To avoid contacting every borrower, an efficient servicer develops a collections strategy to call borrowers at the appropriate time, dictated by their past payment patterns.

Typically, servicers of [government-insured](#) and [conventional-conforming](#) loans begin calling campaigns when payments are not received by the [late-fee assessment date](#) that usually is around the 15th of the month or whenever the grace period ends. At this point, late-payers can account for as much as 6 percent to 10 percent of a servicer's portfolio. For a portfolio of 1 million mortgages, then, a servicer may need to contact as many as 100,000 borrowers in this first month of delinquency.

The EarlyIndicator collections model risk-ranks late-payers during the critical first weeks of delinquency and assigns a numerical risk score to each. A 12-month payment history for each borrower is analyzed to account for the severity and frequency of recent delinquencies and the consistency and dispatch of payments delivered. As shown in *Exhibit 1*, the model differentiates between high- and low-risk loans and suggests a communications strategy for each borrower based on the risk stratum.

In a nutshell, the collections model offers a plan for collections efficiency: Call the right borrowers at the right times with the right message to communicate. With workloads prioritized, servicers can concentrate their efforts on

EXHIBIT 1: Risk Strategies for Loans Behind One Payment (EarlyIndicator Collections Model)

COLLECTIONS SCORE	RISK	BORROWER-PAYMENT HISTORY	DAY TO CONTACT	LOAN COLLECTIONS STRATEGY	STILL LATE AT MONTH'S END (Unaided by EarlyIndicator)
001–006	Highest	History of default	16 th – 17 th	Determine reason for late payment plus when and how borrower will pay	> 45%
007–010	Very high	Paid promptly recently but is now late	19 th	Note unusual situation; determine reason for late payment (oversight, one-time setback, etc.)	15% – 20%
011–044	High	Pays near month's end	20 th – 22 nd	Work to change pattern of late payment; warn late payment means late fees; praise ability to pay every 30 days	25% – 30%
045–066	Moderate	Pays after late-fee date but before month's end	23 rd	Contact only if still unpaid by 23 rd day; warn late payment means late fees; urge quick payment by month's end	16% – 20%
067–070	Low	Pays on time but inconsistently	24 th	Continue to educate that late payments result in late fees	10% – 15%
097–099	Very low	Consistently pays on time; no serious late payments	25 th	Call these borrowers last; maintain a helpful approach	< 10%

Note: Rows 71 through 96 are intentionally omitted and reserved for future use.
Source: Freddie Mac

borrowers in the highest-risk categories, meaning those likely to remain delinquent at month's end, barring any intervention. Similarly, servicers safely can minimize their efforts to contact low-risk borrowers who tend to pay late but well before month's end.

As a result, servicers using EarlyIndicator report they have cut their volume of outbound collections calls by 30 percent to 50 percent without adversely impacting their delinquency [cure rates](#). The reduction in calling frequency generates tremendous savings for

servicing firms, many of which re-deploy resources toward loss-mitigation activity.

Making Contact

Usually, the first communication to late-paying customers is devoted to verifying basic information such as name, address and telephone number. That is not as simple as it seems. When part of a major metropolitan area converts to a different telephone area code, for example, that new piece of information may never reach the servicing files of homeowners

impacted by the change. For that and other reasons, the loan files for up to 25 percent of a servicer's delinquent population show an incorrect phone number or mailing address. To keep misinformation in check, a growing number of servicers are referring loans to skip-tracing services (see "Skip-Tracers Intensify Search for Missing Borrowers," page 11).

As the prospect of [foreclosure](#) grows nearer with each passing day, the necessity of achieving a [right-party contact](#) becomes critical. Otherwise, borrowers may not

Skip-Tracers Intensify Search for Missing Borrowers

"We're sorry, but the number you have dialed has been disconnected or is no longer in service. Please check the number and dial again . . ."

For mortgage **servicers**, deadends like the telephone company's recording are all too familiar, confounding attempts to reach **delinquent** borrowers with surprising regularity.

Despite considerable effort, a servicer may never succeed in personally speaking with a good many borrowers prior to the commencement of **fore-closure** proceedings. When that happens, a borrower may have lost out on the counseling that could have worked out an alternative to foreclosure.

Even by the time a mortgage joins the three-payments due population, a chance remains that the servicer does not possess a correct name, address or telephone number for the borrower. Clearing up such misinformation is difficult, which may contribute to the large percentage of loans that go to foreclosure without benefit of a **right-party contact**.

To minimize losses from foreclosures, investors want their servicers to make a full-blown effort to get borrowers back on track. Servicers, for their part, want to keep day-to-day business costs down.

High Tech to the Rescue

Enter the high-tech **skip-tracer**, an ally in the campaign to locate missing borrowers and possibly recover overdue payments. By scouring extensive data bases through automated search capabilities, skip-tracing services take borrower lost-and-found operations to new heights.

The application of skip-tracing to the mortgage-servicing industry received a significant boost in 1998 when Freddie Mac expanded the company's proactive **loss-mitigation** activities to include a borrower-locat-

ion service. The program—the Customer Assistance Reachout Effort (CARE)—mines public data sources to verify or update existing information in a servicer's data base. Freddie Mac developed the service in collaboration with the skip-tracing vendor now running the program. CARE skip-tracing assistance is offered at no cost on Freddie Mac **guaranteed** loans and is available on a fee basis for non-Freddie Mac loans.



Sifting Through the Clues

Servicers participating in the CARE program may submit loans for skip-tracing once they have passed the 60-day **delinquency** mark. The ersatz detective agency first corroborates the borrower's last known location by using the same address-scrubbing software created for the U.S. Postal Service. An automated search engine then works to cross-reference the address—now certifiably correct—with a phone number, starting with a national directory-assistance search. If need be, the search engine continues to comb other data banks that contain social security numbers and street addresses to make a phone match.

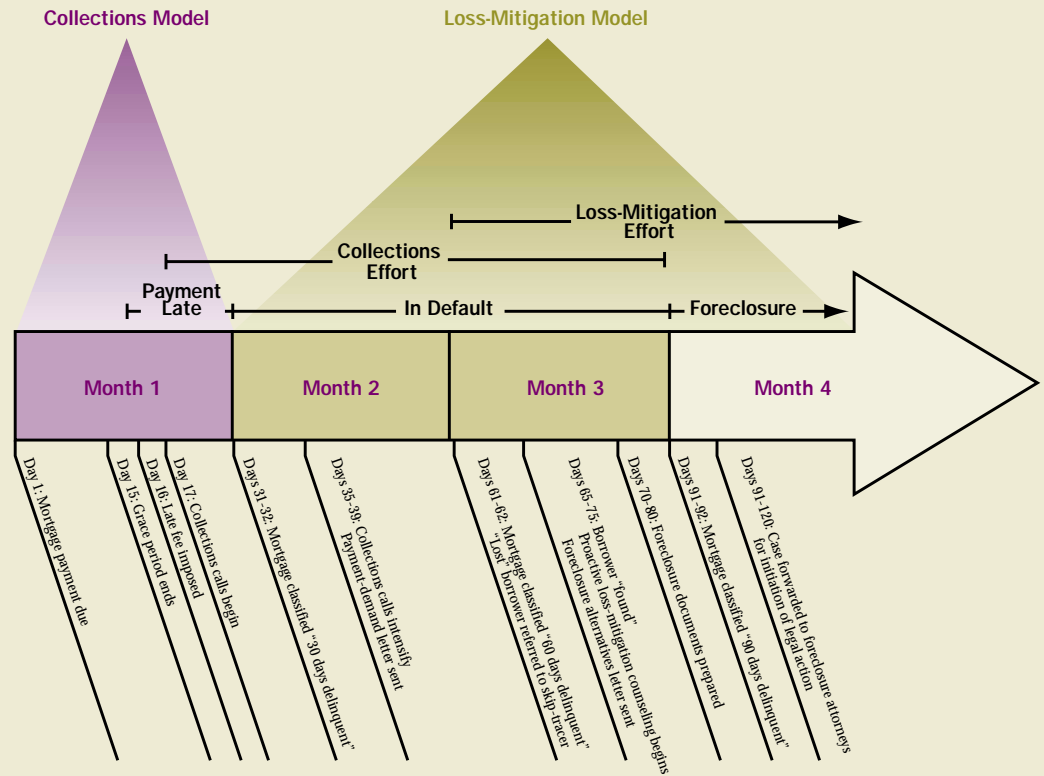
At that point, the skip-tracer reports back to the referring servicer with the results of its search—no new useful information was uncovered, the existing file information is correct as presented or a new or different phone number or mailing address was found. Armed with any helpful information, the servicer resumes efforts to contact the borrower and begin loss-mitigation counseling. Alternatively, the skip-tracer can provide an additional level of service wherein the firm undertakes a campaign of repeated phone attempts to establish personal contact with the lost borrower. If successful, the case is immediately transferred to the appropriate loss-mitigation specialist, who then works to engage the homeowner in proactive foreclosure-prevention strategies. —**Jericho Trianna**

As the Delinquency Clock Ticks

The key dates in the resolution of **delinquent**-loan payments follow a general pattern but tend to differ somewhat from **servicer** to servicer.

How a servicer proceeds depends on mortgage investor-imposed timelines, state laws, individual borrower circumstances, borrower delays and even local economic factors.

Suppose Early-Indicator reveals a high proclivity to **default**. In response, a servicer might construct an aggressive **collections** and **loss-mitigation** timeline similar to the hypothetical one illustrated here.



Source: Freddie Mac

find out about possible ways to avoid losing their homes.

The relative risk presented by the borrower tends to influence the intensity of the servicing strategy and timeline for managing the delinquency (see above, “As the Delinquency Clock Ticks”). Freddie Mac encourages servicers to mail a letter describing foreclosure alternatives to a high-risk borrower around the 51st day of delinquency. For a lower-risk borrower, though, sending the letter between the 60th and 90th days may suffice.

After the first 15 to 40 days

of collections efforts, a point comes when the repeated failure of a homeowner to make good becomes more ominous. Once two or more payments behind, the borrower’s ability to catch up grows increasingly difficult. After all, the monthly mortgage bill is often the most substantial recurring outlay for which a homeowner is responsible, accounting for upwards of 30 percent to 40 percent of monthly income. This is the stage, then, when EarlyIndicator’s loss-mitigation model plays an important role.

Stemming the Flow of Red Ink

When a borrower owes two payments, mortgage loans are rescored to predict the likelihood of the loan generating a loss. The scores help servicers target mortgages for proactive loss mitigation much earlier than ever before (*Exhibit 2*).

Predictive factors considered by the loss-mitigation model include the borrower’s current **equity** position as represented by a positive or negative **loan-to-value (LTV) ratio**, the number of payments outstanding, borrowers’ payment history on the mortgage,

EXHIBIT 2: Characteristics of Loans Two or More Payments Late (EarlyIndicator Loss-Mitigation Model)

LOSS-MITIGATION SCORE	RISK OF LOSS	BORROWER CHARACTERISTICS			LIKELY TO RESULT IN LOSS (Unaided by EarlyIndicator)
		Equity Position	Credit Score	Delinquency	
101-200	Highest	Majority negative	Very Low	Worst cases 8-12 mo. behind	67%-99%
201-250	Very High	Many negative	Very Low	Worst cases 6-8 mo. behind	50%-66%
251-310	High	Some negative	Low	Worst cases 5-6 mo. behind	30%-49%
311-360	Moderate	Most slightly positive	Low when 4+ payments behind Fair when 2-3 payments behind	Worst cases 4-5 mo. behind	13%-29%
361-390	Low	Most substantially positive	Fair when 4+ payments behind Relatively good when 2-3 payments behind	Most < 4 mo. behind	4%-12%
391-400	Lowest	Nearly all substantially positive	Fair when 4+ payments behind Relatively good when 2-3 payments behind	Most < 4 mo. behind	0%-3%

Note: In cases of negative equity, total mortgage indebtedness exceeds the home's value.
Source: Freddie Mac

the loan's interest rate and local economic conditions. Although not required, the inclusion of a recently calculated [FICO mortgage credit score](#) can further refine the model's predictions.

In Month 2, certain borrowers require no more than a redoubling of collection calls and notices to get back on track. For higher-risk prospects, now may be the time to bring in the heavy artillery—loss-mitigation counselors and the foreclosure alternatives they can offer to a borrower.

More than nine in 10 borrow-

ers who are two payments behind will end up saving their homes. Before loss-mitigation scores became available, however, no accurate means existed for identifying which homeowners were most likely to pull out of a foreclosure tailspin. That made servicers far less inclined to direct scarce resources toward helping any borrowers navigate their way past mounting delinquencies.

Extending Good Counsel as Delinquency Deepens

Many times, perfectly valid

reasons account for why borrowers get so far behind on their payments. But borrowers must confront these issues head-on before gaining complete understanding of their options. This is when good loss-mitigation counselors can help borrowers face reality.

In an effort to help borrowers keep their homes, loss-mitigation counselors work with some homeowners in the same way that commercial-lending troubleshooters work with corporate borrowers to propose [debt restructurings](#). These new

EXHIBIT 3: Foreclosure Alternatives

Alternative	Description
Reinstatement	Borrower pays current and past-due loan payments to bring mortgage current
Repayment Plan	Servicer and borrower agree on a repayment plan of additional payments over a specified interval but the terms of the loan are unchanged
Loan Modification	Servicer and borrower agree on a plan to revise the terms of the loan
Assumption	Borrower sells the home to a qualified new borrower who finances the purchase by taking over the remaining mortgage payments
Short Sale	Lender agrees to let a property sale proceed for an amount less than what is owed
Deed-in-Lieu	Borrower avoids foreclosure by deeding the property to the lender

Source: Freddie Mac

specialists in residential mortgage servicing want to give customers a second chance at hanging on to their property by encouraging them to accept a workout plan—perhaps a [repayment plan](#) or [loan modification](#) (*Exhibit 3*).

The earlier counseling begins, the greater the odds that a foundering borrower will catch one of the lifelines thrown by a loss-mitigation counselor. Consider a typical inventory of delinquent conventional mortgages. Of those borrowers who are 30 days past due, only 10 percent eventually will forfeit their homes and produce a loss for investors. Of those who remain overdue after 60 days, the figure rises to 22 percent, and of those still in arrears after 90 days, it climbs to 34 percent. Of the borrowers

whose loans are well into the foreclosure process, almost 75 percent will lose their homes.

Return of Yesteryear's Neighborly Lender

After three years of active duty, the EarlyIndicator behavior-scoring system is now used by Freddie Mac servicers to manage two-thirds of the company's seriously delinquent loans. Moreover, the same servicers under contract with Freddie Mac tend to apply EarlyIndicator in their work with government-insured mortgages and other non-Freddie Mac loans for which they are responsible.

EarlyIndicator can minimize the consequences of mortgage delinquency for borrowers, servicers and investors. The tool can reduce the number of calls to

borrowers by targeting collections efforts at those most likely to remain delinquent at month's end. Thereafter, behavior-modeling software begins to identify borrowers at highest risk of losing their homes. That makes it possible to offer loss-mitigation counseling much earlier in delinquency, thereby helping more late-payers succeed as long-term homeowners.

With EarlyIndicator collections and loss-mitigation scores, today's large servicers can marshal resources more effectively and, ultimately, offer the individualized attention that once served borrowers and the lending industry so well. SMM