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Case Study: Beating The Odds

*Loss Mitigation Scores Helped Wells Fargo Save Resources,
Assist Borrowers In Avoiding Foreclosure*

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Last August, Freddie Mac and Wells Fargo Bank's servicing division quietly began testing EarlyIndicator's loss mitigation scores. The question was what impact the targeted use of the scores would have on the San Francisco-based bank's workouts, foreclosure rates and general costs.

Within six months, Wells Fargo's servicing division reported that it had:

- seen workout submissions increase as a result of streamlined documentation requirements and proactive calling of high-risk borrowers earlier in delinquency;
- focused its resources more efficiently on the relatively few loans that were unlikely to cure without intervention; and
- minimized wasted time and expense by giving a lower priority to borrowers who would cure without intervention.

According to Joan Coppenrath, Wells Fargo's vice president for default management, "EarlyIndicator had an immediate and unexpectedly significant impact on our operations by enabling us to realize the full potential of our collection and loss mitigation staffs."

Created by an alliance between Freddie Mac and the Mortgage

Guaranty Insurance Company (MGIC), EarlyIndicator is a comprehensive default scoring tool designed to generate scores that risk-rank delinquent loans and help servicers increase the efficiency of their collection and loss mitigation programs. As a result, the tool helps servicers realize more value from their Freddie Mac portfolios and promote our mutual mission to promote homeownership by helping more borrowers avoid foreclosure and succeed as long-term homeowners.

Trimming expenses

Currently, 40% of Freddie Mac's portfolio of 7.5 million mortgages is being managed by servicers using EarlyIndicator. To date, users report that the collection model alone is trimming as much as 30% from their collections expenses. In addition, the Well Fargo experiment shows the loss mitigation models also have the potential to achieve more workouts in a cost-effective manner.

Under Freddie Mac's "Champion/Challenger" experiment, Wells Fargo divided its delinquent loans

where borrowers owed three or more payments into two groups. With Group A, the servicer followed its current work process - "the Champion." But, with Group B, the servicer used EarlyIndicator scores to identify the delinquencies most likely to result in loss and proactively called borrowers for foreclosure alternatives - "the Challenger" process. Servicers typically have many delinquent borrowers owing three payments. Not surprisingly, they are reluctant to devote resources to the very labor-intensive process of actively pursuing foreclosure alternatives, especially when almost 80% percent will eventually pay off or reinstate.

The Champion/Challenger experiment was intended to see if EarlyIndicator could overcome that reluctance by accurately identifying the relatively few borrowers most at-risk of heading to foreclosure.

By April 1998 (after six months of experimentation), EarlyIndicator's loss mitigation score enabled Wells Fargo to target its resources and triple the number of workout packages it received from borrowers. Version 3.0 provides servicers with a series of enhanced loss mitigation models that measure the loss risk of loans at every depth of delinquency: 30, 60 and 90 days, and through foreclosure.

Scoring workouts

EarlyIndicator was created to apply the latest advances in credit scoring technology to the problems of servicing delinquent mortgages while helping borrowers avoid foreclosure. Consequently, scores are tailor-made to help servicers sift through the number of loans that are delinquent at the end of the month and accurately pinpoint those loans that are likely to result in loss.

In operation, the loss mitigation models analyze several different variables including:

- payment history,
- loan type,
- age of delinquency,
- loan-to-value ratios,
- foreclosure laws,
- credit scores (if available), and
- local economic indicators.

The models' strongest attribute is its mark-to-market collateral assessment capability. (Freddie Mac has access to millions of updated repeat real estate sales transactions in every U.S. county.)

The program's proprietary scoring models then translate this data into a potent risk-ranking tool - an EI loss mitigation score - that servicers can use to identify and focus on the borrowers who owe two or more payments and are most likely to produce a loss.

EI loss mitigation scores are reported in three digit formats, from 101 to 400. The higher the score, the lower the probability that the servicer must take action to bring the loan current to avoid a foreclosure. (EI's collection score for loans in their first month of delinquency are also reported in a

EarlyIndicator Scores Also Identify Cure Rates	
<i>As EarlyIndicator Scores increase, so do cure rates. The above data is based on sample scores from every stage of delinquency and the foreclosure scorecard.</i>	
EI Scoring Range	Cure Rate
<=130	6.1%
131-200	22.9%
201-300	53.4%
301-370	81.5%
371-395	95.3%
>395	99.2%

SOURCE: Freddie Mac

three-digit format, but in a lower range: 001 to 099.)

By incorporating a sequence of scorecards for each depth of delinquency, EarlyIndicator can generate loss mitigation scores that accurately track the risk of loss as borrower behavior and default severity changes with each additional month of delinquency.

The loss mitigation model's scorecards are keyed to loans at each depth of delinquency:

- two payments owed,
- three payments owed,
- four or more payments owed, and
- in foreclosure.

Consequently, the separate scorecards increase the risk assessment power of the scores.

This is important because it gives servicers a tool to help them potentially realize more value from their loss mitigation program by calibrating their responses to a delinquency's specific duration.

Successful intervention

Ultimately, the test of a score's value is how well it can predict which mortgages are likely to cure and which aren't. The more accurate the score, the more precisely servicers can target their activities, minimize waste and maximize impact.

EI scores consistently identify the few borrowers who are really at risk, which, in turn, enables servicers to avoid the time and expense of contacting every borrower who is two or more payments behind. This gives servicers more time and resources to provide foreclosure alternatives to qualified borrowers. With servicers investing a few hundred dollars on each loss mitigation package prepared, the potential savings can be substantial.

In general, almost all of the loans with scores above 395 will successfully reinstate. At the same time, more than 90% of the mortgages with EI scores of 130 or less will eventually generate a loss. (See Table 1.)

Examining a table of loans resulting in loss at different stages of delinquency further demonstrates the power of the loss mitigation score. Overall, among

delinquent loans that have EI scores in the 396 to 400 range, fewer than 1% will result in a loss. As the scores drop, the odds of a cure decline. Among loans with scores between 361 and 395, only 5% will result in a loss. By contrast, in the lowest scoring range (101 to 130), the probability is that 94% of the loans will result in a loss.

EI's multiple scorecards are capable of calculating the probability that loans will result in a loss versus a cure at each stage of delinquency. As borrowers fall further behind in their payments, more mortgages will receive lower scores. But, the probability of a loan curing still remains very high for high scores (396 to 400) and very low for mortgages with low scores (101 to 130).

By rescoring their delinquent portfolios each month, servicers can effectively identify the loans most at risk and then deploy the resources and strategies best suited to minimizing losses at each depth of delinquency. Consider

Table 1: Scoring with EarlyIndicator

EarlyIndicator Scores can predict the likelihood of a delinquent loan producing a loss for each stage of delinquency. Example: for loans with EI Scores in the 396-400 range, less than 1 percent will generate a loss, but for EI scores in the 01-130 range, 94% are likely to produce a loss.

Loss Rates ¹ and Delinquent Loan Shares by EI Score Range								
EI Score Range	All Loans		Two Payments Due		Three Payments Due		Four or More Payments Due/ Foreclosure	
	% of Delinquent Loans	% of Loans Resulting in Loss	% of Delinquent Loans	% of Loans Resulting in Loss	% of Delinquent Loans	% of Loans Resulting in Loss	% of Delinquent Loans	% of Loans Resulting in Loss
396-400	10-15%	<1%	15-35%	<1%	1-5%	2%	1-2%	2%
361-395	30-40	6	40-60	5	30-50	6	10-15%	7
326-360	5-15	17	10-20	18	10-20	17	8-15%	17
201-325	20-30	40	1-10	37	20-30	41	30-40%	40
131-200	5-15	77	<1	71	<6	75	15-30%	75
101-130	1-10	94	N/A	N/A	<1	86	8-22%	94

¹ Loss Rates-REO, preforeclosed short sale, third-party sale, chargeoff * N/A - too few loans in sample

SOURCE: Freddie Mac

Table 2: EarlyIndicator scores identify large shares of future loss producing loans

EI scoring ranges are calibrated to enable servicers to target the loans most likely to go to loss. For looking only at loans on which two payments are due, by expanding the top of the range from 300 to 325, servicers can increase the percentage of future producing losses they can identify from a third to a half.

Early Indicator Score Range	Share of Loans on Which Two Payments Are Owed	Share Of Future Loss Producing Loans
101-300	<6%	33%
101-325	5-10%	50%
101-360	15-20%	65%
101-395	65-85%	97%

SOURCE: Freddie Mac

Table 3: The EarlyIndicator Champion/Challenger Scorecard

Champion or Challenger?	Total Mortgages	EarlyIndicator Score Range	Total Workouts Submitted	Workouts as % of Right Party Contracts
Challenger Process (w/ EI Scores)	181	191-280	18	17%
Champion Process (w/out EI Scores)	168	191-280*	5	5%

* Scores added for tracking purposes only

SOURCE: Freddie Mac

the following two examples:

Two payments behind

Risk: Among mortgages that owe two payments, fewer than 6% will have EI scores between 101 and 300, yet these loans represent almost a third of the loans that will ultimately produce a loss. Casting the scoring net a little wider to the 101 to 325 range will capture between 5% and 10% of delinquent loans in this category, but around 50% of the loans that will generate losses; the 101 to 360 range will capture between 15% and 20% of delinquent loans, but 65% of the loans that will generate losses (See Table 2).

Possible actions: In terms of action, servicers should issue a demand letter by Day 45 for scores less than 325, and immediately commence loss mitigation efforts, and begin gathering information to refer loans to foreclosure by Day 65. If foreclosure alternatives cannot be negotiated, servicers should then refer loans by Day 65 (and no later than Day 90).

Three payments behind

Risk: At this point, mortgages with EI scores under 300 will account for approximately 15% to 30% of the 60-day inflow, but 65% of the loans that go on to create a loss. Mortgages with scores under 360 may account for as much as 50% of the inflow and 85% of the loans that result in loss.

Possible actions: Mortgages that are in their third month of delinquency and have EI scores under 200 should be referred to foreclosure between Day 65 and

Day 75. Borrowers in this range are also candidates for Freddie Mac's enhanced short sale program, which is targeted specifically at mortgages that have such a high likelihood of loss that Freddie Mac is willing to waive many of the documentation requirements normally associated with workouts. Loans with EI scores in the 201 to 300 range should be targeted for intensive loss mitigation efforts.

Achieving new efficiencies

How does this process work in practice? Let's turn back to the Wells Fargo experiment. Overall, the test involved 349 mortgages that owed three or more payments and had EI scores that ranged between 190 and 280 - about 17% of the bank's Freddie Mac delinquent loan portfolio. Wells specifically set aside 181 loans for the Challenger process with EarlyIndicator and 168 loans for the Champion process.

Challenger mortgages received EarlyIndicator scores and were managed accordingly. For loans that received scores between 190 and 280, Freddie Mac requested that proactive calls be made to pursue a foreclosure alternative with borrowers. As previously noted, about four out of five loans where three payments were owed eventually reinstated. However, more than 50% of the mortgages with scores between 190 and 280 will go to loss without intervention.

And, since these loans only constitute 17% of mortgages with three or more payments owed, Wells' loss mitigation specialists had a targeted group for proactive loss mitigation. What's more, because these borrowers were contacted when only three payments were past due, Wells Fargo's staff had more options to pursue with the borrowers.

The results were encouraging. As of March 1998, the Challenger process that used EarlyIndicator scores resulted in the submission of more than three times as many workout packages than the Champion process that didn't. Specifically, the EarlyIndicator Challenger process resulted in 18 workout packages; the other process produced five. What's more, 17% of the borrowers in the Challenger group were offered workouts where a right party contact was achieved versus 5% for the Challenger process. Although these numbers are small, they do underscore the enormous potential of proactively targeting borrowers for workouts and other actions. (See Table 3).

Additional evidence of scoring's power is demonstrated by application of Freddie Mac's "enhanced short-sale" program.

As mentioned, under this program servicers are allowed to substantially streamline Freddie Mac documentation requirements on all short sales with EarlyIndicator scores of 200 or less. Because of prior successes with this program, Freddie Mac allowed Wells to offer an expedited short-sale for 584 Freddie Mac mortgages with scores below 190. Between August 1997 and March 1998, a total of 86 workout packages were submitted. What was even more impressive was that 36% of the loans with a right-party contact had a workout package submitted.

Although it's too early to determine specific savings or other long-term effects, "with EarlyIndicator, we finally think that we are on the right road for more effective delinquent

borrower management," says Wells Fargo's Coppenrath.

"Freddie Mac and MGIC have given us a tool that is already demonstrating great potential

for supporting our long term delinquent loan strategy to reduce industry credit losses, effectively manage our human resources, and help more borrowers avoid foreclosure," she says.

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