How Do You Value Risk?

While speed and efficiency are still important factors, the overwhelming focus for the coming year is quality.

By Rich Kuegler

Five years ago, lenders were primarily interested in one thing from technology: speed. With the mortgage boom in full swing, the focus was on automation and integration of system enhancements that would help them close as many loans, as rapidly as possible. This applied to virtually every step in the mortgage process. Compliance review, credit checks and property valuations were all treated more like commodities to be processed quickly and cheaply.

As the market turned from 2008 through 2010, lenders focused primarily upon survival. They needed to hang on, making difficult decisions and cutting costs that enabled them to survive the downturn and the resultant drop in application volume. Those that survived are the organizations that have rebuilt their processes and revamped technology capabilities to support the needs and realities of the new market.

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2011 will be known as the year that the rules changed. While proposed legislation and regulatory updates have caused major changes in the lending process during each of the past few years, the passage of the Dodd-Frank Financial Reform law and creation of the Consumer Financial Protection Bureau (CFPB) will once again shift the rules.

As of the beginning of the year, there is still a lot of uncertainty to what some of the specific rules might look like. For example, the "qualified residential mortgage," which will outline those mortgages exempt from a mandatory five percent retention, will not announce its guidelines until this month. Other regulations, such as the Real Estate Settlement Procedures Act (RESPA) and Truth in Lending Act (TILA), are still working out how to work together under the control of one agency.

In December, the federal regulatory agencies issued their guidance on appraisal and evaluation processes. The new rules replace the Home Valuation Code of Conduct (HVCC) and outline specific guidelines for selecting and compensating appraisers as well as the validation of appraisals. The guidelines emphasize processes that can insure independence and accuracy in the appraisal process. Again, the focus remains on quality; for both the collateral valuations products used in underwriting and the process by which these products are delivered and validated.

Imagine if someone promised you the chance to invest in a stock that would never drop. You would laugh at them as you kept your wallet closed tight.

Yet lenders and consumers alike fell into the trap of only expecting positive growth in real estate, despite the historical foundation for rises and falls in real estate values. When adjusted for inflation, housing prices saw dips in the early 1970s, the early 1980s and the early 1990s before going on the historic bubble that peaked in 2006.

But somehow, investors, homeowners, lenders and the government were unprepared for the drop that began in 2007, and the recently developed appraisal methods were not equipped to handle rapid price drops.

Just as smart investors know the stock market rises and falls, lenders know that the real estate market will do the same. Complicating the matter is the fact that there is no national market for homes. The price of homes varies greatly from state to state, city to city and even ZIP code to ZIP code.

The new appraisal guidelines will introduce some changes in the utilization of different products, including the requirement that new appraisals or evaluations must be secured if the reported market value has changed due to passage of time; volatility of the local market; changes in terms and availability of financing; natural disasters; limited or over supply of competing properties; improvements to the subject property or competing properties; lack of maintenance of the subject or competing properties; changes in underlying economic and market assumptions, such as capitalization rates and lease terms; changes in zoning, building materials, or technology; and environmental contamination.

In 2011, lenders should look toward technology tools to help validate their information needs for property valuation. These quality review and validation tools include advanced algorithms that evaluate key criteria within the loan files and incorporate market data to determine the validity of the valuation report. This type of tool can help underwriters to identify those loans for which property values may have impacted combine loan-to-value (CLTV) or other key risk factors, thus requiring a more detailed reevaluation. As these tools continue to improve, lenders will be able to customize the programs to incorporate unique business rules and various loan parameters.

This can also assist servicers in better managing portfolio performance. Using these validation tools, portfolio managers and servicers receive a comprehensive report that classifies individual properties into risk-based groupings or tiers, along with the data and analytics needed to support additional targeted analysis at a loan level. By identifying potential risk at a loan level, servicers can more effectively determine which properties may need no further evaluation, those that need someone to take a closer look to verify the value and those that may be most at risk and will require complete reevaluation by the most experienced servicing associates.

For example, a portfolio validation tool could highlight the risk associated with a property where value has dropped by more than 30% in the past year, putting the loan into a negative equity situation. By quickly assigning the at-risk property to an experienced home retention counselor, the lender can begin to take steps with the borrower to maintain loan performance or utilize the information to help direct the borrower into a government-sponsored modification program.

The other factor lenders will be paying special attention to in 2011 is the quality of the borrower. Prior to the market's downturn, credit was readily available and the continued increase in home price appreciation meant that collateral could overshadow the underlying capacity issues. The decrease in home values, plus other economic factors are driving a need for better understanding of the borrower's ability to repay any loan and the scope of any liabilities, increasing the scrutiny of the review of credit worthiness.

Lenders will be looking to technology platforms that can quickly and accurately review all information available —income, credit, debt load and payment histories—when underwriting and servicing loans.

Lenders should look to tools that can provide the credit analysis and information that enable them to make informed decisions on loan applications during all phases of the mortgage process. These may be imbedded in Loan Origination Systems or delivered through connection to trusted information partners. Lenders have always realized the importance of managing the information available to them to more effectively underwrite loan applications.

The expanded role of loan quality initiatives by major investors, including GSEs, will drive additional due diligence, requiring lenders to look for tools that help them to obtain data on up-to-the-minute credit changes after the application is submitted, trade line validation and other research.

In loan servicing, identification and awareness of the warning signs of a borrower about to go into default is the first step in managing the credit risk of existing loans. Any portfolio risk assessment begins with an evaluation of individual loans and borrower profiles. Lenders can use automated tools to sort through a portfolio and assign risk ratings, enabling them to focus first on the most at-risk, and likely to default, loans.

The primary indicators for possible default have not changed drastically over the years, but the speed at which these factors change in today's market has made the task of keeping up with all the loans in a portfolio more difficult. Below are four areas servicers should monitor.

Missed/Late Payments: This is the most obvious of early indicators, but lenders should also keep an eye on other revolving debt payments. Changes to payment patterns among other accounts may suggest that borrowers may be trying to balance growing debt loads, since many borrowers will skip other payments to remain current on their mortgages.

Delinquent Accounts: Miss too many payments, and delinquent trade lines become another obvious warning.

Increase in Utilization of Credit: Lenders should also be on the lookout for unusual increases in credit utilization. As more borrowers are facing financial struggles, an increase in the activity on a credit card or a sudden access of secured lines of credit may signal upcoming issues with the borrower.

Unusual Activity in Other Accounts: For lenders who work in multiple-account environments, such as banks and credit unions, the activity on other accounts is another good indicator of a borrower's health. The key to managing these signs is the ability to view a complete picture of a borrower's financial status, perhaps through a strong CRM platform that links all accounts the borrower holds.

Another factor in judging credit-worthiness is the ability to sell to investors. Fannie Mae's Loan Quality Initiative (LQI) was launched last year to eliminate the delivery of ineligible loans and reduce the risk of repurchase. Fannie Mae conducted an extensive analysis to determine the primary indicators of repurchase requests and launched the LQI to identify and implement policy.

Lenders will need to adapt technology tools that can provide the credit checks and quality controls that ensure compliance with Fannie Mae investor guidelines as well as other investors. New software tools can help Fannie Mae lenders to compare existing credit reports to new repository data.

Managing the quality of property valuations and borrower credit could be one of the most daunting tasks facing lenders in 2011. Thankfully, the technology and experience is available in the marketplace to help support lenders' need for quality. The tools and solutions will enable lenders to be more consistent when applying enhanced quality review processes and controls. Knowledge is power. ❖

About The Author

Rich Kuegler is Vice President of Business Development for Wilmington, Del.-based MDA Lending Solutions, a provider of information solutions that can improve the decision making and operational performance of customers by reducing the time, cost and risks involved in real estate transactions. The company offerings include MDA DataQuick, MDA MindBox and traditional settlement services, such as collateral valuation, title and property search, flood compliance, residential credit and closing/settlement products.

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