

Stemming Losses, Regaining Profitability

BY CLAYTON BAKER

What a difference three short years make. In 2005, mortgage originations were at historic highs, and the industry was riding the wave of increased volume. But today, lenders with significant mortgage lending activities are suffering. They are being squeezed by an almost unprecedented combination of internal and external forces impacting their operations.

As of late September, the FDIC had been called in as receiver or conservator for 13 U.S. commercial banks, compared with only four in 2007. In 2005 and 2006, there were no bank failures. Among the most vexing problems facing today's lending organizations are shrinking loan volumes, swelling credit losses, liquidity challenges and significant volume shifts from production to servicing and default operations.

To deal with this onslaught, many institutions with substantial mortgage lending operations need to rewrite their playbooks. While lenders must continue to vigilantly - and profitably - originate new loans, they must also focus on multifaceted approaches for safeguarding and managing held assets while minimizing losses.

For mortgage lenders and other market entrants such as private equity firms, reducing losses requires them to deal effectively with nonperforming loans. In the second quarter, according to TransUnion, national mortgage delinquency rates hit 3.53 million, an increase of nearly 51% over 2007. An additional 3

POINT OF VIEW

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million borrowers could face trouble by the end of 2009, experts estimate. Mortgage servicers must restructure these problem loans and find creative workout options to stave off more foreclosures. And they are in dire need of new strategies and tools to do so: creative ways to modify the loans to mitigate losses, proactive approaches to handle loans on the verge of defaulting, and better analytical tools to pinpoint and prioritize borrowers more likely to become delinquent.

Meanwhile, market shifts have compelled banks to alter their products and distribution models. Many institutions are curtailing third party-originated loans and emphasizing retail production. Certain secondary markets - such as those for subprime and alt-A loans - have dried up, forcing many lenders to focus on

originating conforming conventional and government loans. At the end of 2007, Fannie Mae and Freddie Mac owned or guaranteed \$4.9 trillion worth of mortgages. As of September 2008, that figure had risen to \$5.4 trillion.

As banks work to contain losses, revamp their product mix and reconfigure their balance sheets amid the crisis, they are also faced with excess capacity issues. They no longer need so many loan originators, but, at the same time, the banks must rapidly ramp up staff levels to handle problem loans and real estate-owned properties. A growing number of banks are shifting production staff to similar roles in default. For example, underwriters are being retrained as loss-mitigation negotiators, while processors are shifting to default-fulfillment roles.

Lending organizations must add new legal and regulatory tests to this volatile mix. They are faced with an unprecedented deluge of litigation and fraud issues. They also need to answer pointed questions about fair-lending practices and consistency in how they treat borrowers through the loan-modification, loss-mitigation and foreclosure processes.

While the challenges are plentiful, they are not insurmountable. Mortgage lenders must take specific, strategic steps today not only to minimize their losses, but also to prepare for the future. By acting now, they can position themselves for success in a new mortgage market, a markedly different one from the one to which they have become accustomed.

Specific recommendations are as follows:

- Aggressively streamline operations and infrastructure to meet demand.
- Consolidate and retool core systems to support new market requirements.
- Deploy creative foreclosure prevention and REO strategies.
- Strengthen process and decision-making transparency.
- Tightly link legal and regulatory requirements with operational controls to ensure compliance.

Streamlining operations begins with human capital. Mortgage banks need to pinpoint new sources of capacity and talent, including offshore and outsourced operations, which can be tapped as needed without incurring a fixed expense. With adequate retraining, front-office staff can be redeployed to back-office loss-mitigation work. Lenders should also consider exiting products and channels where they do not have distinct market advantage and profitability. The operations blueprint must also be reevaluated - the number, size and scope of operating centers and related infrastructure were designed to support an environment that no longer exists.

Consolidating and retooling systems and processes also become prerequisites,

given the new mix of products in today's market. In general, institutions must target more of their work toward conforming loans and FHA/VA products and ensure that the structuring of new loans is properly controlled through the use of automated tools. Loan processing and closing must also be made more efficient and scalable because margins are much tighter on these products. To reduce risk and improve loan quality, lenders also need tighter anti-fraud, collateral valuation and borrower analysis procedures and systems to scrutinize the products and channels they continue to support.

In addition, lenders must devise new, more creative strategies to prevent foreclosures and handle REO properties and invest in technologies to execute on them. These include automated decision-support software that can improve throughput, better target the allocation of skilled resources and further optimize solutions for borrowers. Other tools include constantly updated data "dashboards" to enable lenders to better monitor overall portfolio value and risk by providing more accurate views of loan quality and distribution. Equally important, they can improve individual loss-mitigation decisions.

Finally, compliance with new and

constantly evolving legal and regulatory parameters must be integrated into operations on a day-to-day basis. Mortgage bankers can use analytical software and decision-support applications to ensure that borrowers in default are treated consistently and according to fair-lending laws. Bankers also have to keep in mind that they will need comprehensive and increasingly robust reporting tools to demonstrate to regulators the effectiveness of their processes, as well as continuous testing and validation methods.

Today's realities represent nothing short of a sea change for mortgage banks. To remain viable in this new marketplace, they will have to move quickly to alter business models, operations and infrastructure. The institutions that are able to adapt most proficiently, however, beginning with the management of nonperforming loans, will be able to curb further losses and ready themselves to improve profitability.

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