



FROM THE HILL

Mods Make Sense

No Matter How Ocwen Looks at It, Loan Modifications Are Better Business for Servicers Than Foreclosures

| PAUL A. KOCHES |

The National Consumer Law Center (NCLC), Inc., is an effective, concerned organization that works to advance justice and fair treatment for consumers, especially those who are economically disadvantaged.

So it is natural—and, of course, very helpful—that NCLC has been researching the mortgage crisis and speaking out on behalf of homeowners. Recently, NCLC explored important and troubling questions. If mortgage modifications—now advocated and incentivized by the Obama administration—are the key solution to the crisis, why have relatively few occurred, and at a slow pace, while foreclosures continue at an unprecedented, damaging clip?

NCLC's October report, "Why Servicers Foreclose When They Should Modify and Other Puzzles of Servicer Behavior: Servicer Compensation and Its Consequences," underscores some important points:

- » The pace of loan modifications by the servicing industry is generally too slow;
- » The national foreclosure rate is still way too high; and
- » Any successful attempts to redress the foreclosure crisis will, of necessity, involve loan modifications.

INCORRECT TO THE CORE

In exploring the conundrum of high foreclosure rates and relatively sluggish modification rates, the NCLC report takes loan servicers to task. That's certainly a reasonable approach as servicers are the entities responsible for modifications. The NCLC analysis of servicers, however, is based on some incorrect core assumptions. It says servicers make more money with foreclosures, so therefore, they have no real financial incentive to pursue sustainable, lasting modifications.

That simply isn't true. Servicers rarely, if ever, make money when there's a foreclosure. They're expensive, time consuming, and draining. REO, in this real estate market, just isn't a good business. On the other hand, modifications *are* good business—and make financial sense for servicers—when they're done prudently and carefully. The fact is, in most cases, a modified loan, even one in which the principal has been adjusted, generates more income for a servicer than a foreclosure.

OPERATIONS NOT UP TO SPEED

Perhaps the real reason for the generally slow start to modifications is more operational than financial. Servicers, at this time, simply do not have sufficient know-how, capacity, and experience to

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communicate with their customers to design and effect sustainable modifications on scale with the problem—and they're not turning to the outside resources that do have the platform and capacity to help.

It's worth noting that at Ocwen modifications are a key part of the business and operational strategy, and the company has led the industry in the rate of permanent modifications under the Home Affordable Modification Program (HAMP). Ocwen is in this position because it has traditionally worked almost exclusively with high-risk—i.e., subprime—loans and has invested \$150 million in R&D for scalable loss mitigation technology and analytics to accommodate significant numbers of modifications. Major players

are recognizing Ocwen's capabilities and are increasingly turning to it to reduce delinquencies and losses and for modification assistance. Recently, large financial institutions have sent Ocwen approximately \$15 billion in their mortgages for special servicing and rehabilitation.

Ocwen believes that modifications are good for investors, good business for its company, good for distressed homeowners, good for communities, and good for the housing market overall. Doing good is, more often than not, good business.

FORECLOSURES NOT WALLET-FRIENDLY

The first misguided assumption on NCLC's part is that servicers usually make

money on foreclosures. The reality is that servicers make money when delinquent loans become reperforming. Servicers collect the most servicing fees and incur the lowest costs when this is the case. Foreclosures, in contrast, are costly—and it is simply not true that the servicer always recovers its expenses in foreclosures. Foreclosure is not only a tragedy for a homeowner, but given the all-time-high loss severity rates in the current market, it's a major loss as well for loan investors (i.e., the owners of the loans). Servicers doing their jobs properly will and should seek alternatives such as modifications to mitigate losses for their clients.

The NCLC grossly underestimates the impact of the loss of monthly servicing fees when there's a foreclosure. Those fees, which

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resume when there's a sustainable modification, are really the lifeblood of a servicing business. Losing them, in an environment where there are no new mortgage securitizations on which to bid for servicing rights, is damaging.

Similarly, NCLC trivializes the servicer incentive and success fees provided for permanent modifications pursuant to the government's HAMP program. The NCLC report asserts these fees aren't enough to induce servicers to modify, but the reality is these additional incentives are meaningful and revenue-generating.

Finally, NCLC advances the incorrect perception that servicers do well by shunning modifications because they make

a lot of money from late fees. That just isn't true. The reality is that late fees, which are rarely collected in a foreclosure-bound situation, don't come close to covering the cost of financing advances that servicers must make to investors in case of delinquent loans.

A WINNING HAND

Now for the real story: The bottom line at many servicing shops, including Ocwen, is that the overriding financial incentive comes from adhering to contractual obligations to service the loans, and and resolve delinquencies, in the best interest of the investors. So, when a servicer's metrics indicate a higher investor net present value for a modification than a foreclosure—which

is often the case in this environment—the servicer is required to modify the loan.

In short, the financial cards are *not* stacked against modifications arranged by servicers.

So where is the disconnect? Why are modifications happening so slowly in the industry?

PRE-EXISTING CONDITIONS

The root cause is not insufficient servicer incentives; it is instead the pre-existing shortage of industry infrastructure and capacity combined with the time lag needed to effectively expand the same. The real call to action should be for the industry to redouble its effort to ramp up in terms of technology,

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know-how, and analytics—or at a minimum to find the right modification partners who can help support the effort.

Anticipating an uptick in delinquencies, Ocwen beefed up its loss mitigation staff by 50 percent in 2007. No one, however, could have predicted the tsunami wave of defaults that was about to hit.

At the same time, many large banks had diversified their traditional prime loan origination business by expanding into subprime lending and servicing, often through acquisitions. But successfully integrating a subprime mortgage operation into a prime culture is difficult—they are

entirely different worlds. Prime delinquency and foreclosure rates have always been a small fraction of subprime's; servicing the latter effectively requires many more "high-touch" processes and procedures. It's not surprising, then, that the big banks were overwhelmed with the unprecedented spikes in subprime delinquencies brought on by the mortgage crisis and continue to struggle to prevent foreclosures even now.

SUSTAINABILITY AND SCALABILITY ARE KEY

Even with the advantage of decades of subprime servicing experience and

specialized technology, Ocwen was scrambling at the outset of the mortgage crisis to get defaults in its portfolio under control. Ocwen increased staff by another 30 percent in early 2008. More important, Ocwen decided its basic loss mitigation approach needed to be elevated to the next level—and fast. The forbearance plans and the other techniques that enabled the company to lead the industry in containing losses by avoiding foreclosures would no longer be enough. Nonperforming loans now needed to be fundamentally re-underwritten if there would be any hope of arresting delinquencies.

Ocwen knew full well, however, that the success of any loan modification program would be measured on two essential metrics. It would need to be both *sustainable* in providing reduced monthly payments that homeowners can truly afford and to which they will commit long term, as well as sufficiently *scalable* to meet the high number of homeowners in distress. Of course, as a third-party servicer, Ocwen also needed to ensure that its modifications were NPV positive for the owner trusts.

So from the outset of the pre-HAMP modification program, and now under HAMP, Ocwen has been working hard to make modifications stick. Ocwen's technology utilizes advanced optimization models to evaluate the best resolution alternatives. Ocwen also provides one-on-one financial counseling to the homeowner, aided by interactive scripting engines incorporating behavioral science research for more effective communication with distressed borrowers and more lasting resolutions.

PICKING THE RIGHT PEOPLE PAYS OFF

Ocwen's behavioral science department has also confirmed—through research, testing, and six sigma analytics—the optimal personality traits and cognitive

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ability to guide the successful hiring and training of its customer care staff. With these tools, Ocwen can bring on high-performing home retention consultants in 90 days or less. Psychology has thus become an integral part of an overall loss mitigation technology platform that is robust, scaleable, and enables Ocwen not only to cure and control delinquencies in its own portfolio, but also to ramp up quickly to deploy additional capacity for third parties.

The effort and investment are paying off. Ocwen modifications' re-default rate of 25 percent is far lower than the industry average of 50 percent, as reported by the OCC/OTS. According to a mid-2009 Bank of America Mortgage Credit Research Report, Ocwen has the highest industry average of modifying fixed-rate and adjustable-rate subprime mortgages more than 90 days' delinquent into current, performing loans.

The Ocwen approach has been especially effective within the Treasury Department program. As noted by Professor Alan White, oft-quoted expert on foreclosure prevention and the HAMP program, "Ocwen . . . has converted 89 percent of borrowers who were on temporary modifications in August to permanent mods by November," while the conversion rate for large banks for the same period ranged from 11 percent to fewer than 1 percent. Ocwen's pull through of permanent modifications continues to outpace industry by a wide margin according to Treasury's most recent monthly HAMP report card.

TIGHTENING COMMUNITY TIES

In addition to raising the bar on analytics, capacity, and technology, there are other ways to add scale and sustainability in the servicer-based loan modification process. One is for servicers to work closely with community groups. They can help reach out to distressed homeowners and help them stabilize their finances and communicate with servicers in

candid, productive ways. Community and grassroots groups are also good brainstorm partners and allies for servicers when it's time to call for government action.

Ocwen recently convened more than 30 representatives of grassroots and national housing advocacy organizations for a roundtable discussion to share new ideas and insights related to preventing foreclosures and helping homeowners. The Ocwen and community group representatives agreed upon a number of imperatives that could streamline and accelerate the loan modification drive. The imperatives include:

- » Working closely with Treasury to arrive at more flexible guidelines, so more distressed homeowners qualify for mortgage modifications under HAMP;
- » Developing a national HAMP awareness and information campaign to increase homeowner outreach;
- » Focusing more intensely on homeowners who are unemployed or under-employed and thus need state or federal assistance to qualify for mortgage modifications; and
- » Encouraging greater collaboration between servicers and grassroots groups in providing real-time solutions for homeowners, including being more proactive about helping borrowers early on, before they face the prospect of foreclosure.

The National Consumer Law Center underscored an important issue by looking into why foreclosures continue at too rapid a rate and why the loan modification movement seems slow in taking hold. Contrary to its thesis, however, financial incentives do not favor foreclosures over modifications. Modifications, in this environment, are actually good for the servicing business, as well as good for homeowners, communities, and the property market. But servicers must do their part to build the capacity and expertise—or look outside for help. **DS**

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