Getting Borrowers' ATTENTION

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The Responsible Homeowner Reward program is one of a new breed of solutions designed to head off default by incorporating behavioral economics.

Although mortgage delinquency rates seem to have leveled off recently, falling home prices continue to exert upward pressure on long-term default rates. Banks, funds and mortgage insurers are beginning to evolve their operations to become more proactive when it comes to establishing a connection with their borrowers. Furthermore, cultivating these relationships over time can provide both new insights into consumer behavior and help gather information to better serve both parties.

Large banks' and servicers' back-office operations are mostly a network of legacy systems that have been amassed over the years as a result of bank acquisitions and industry consolidation. Today, servicers are handling a multitude of new products and initiatives as well as executing government-mandated programs such as the Home Affordable Modification Program (HAMP) and Home Affordable Refinance Program (HARP) to address a record number of loss-mitigation and servicing activities. What's more, servicers are facing a phenomenon never seen in the mortgage industry—widespread negative equity.

Systems that sufficed only five years ago are now obsolete and overwhelmed, along with their associated customer contact methodologies and tools. Lastly, the primary servicing model was built for annual delinquency rates below 4 percent. With the annual delinquency rate currently running near 10 percent, most servicers' infrastructure and operations are stretched to the breaking point.

To begin with, most lenders and servicers already have a high incidence of bad data contact, and weak homeowner outreach strategies diminish the overall success of all loss-mitigation efforts. Despite the fact that most of the future losses on mortgage portfolios will derive from today's high combined-loan-to-value

(CLTV) ratio current loans going delinquent sometime in the near term, many financial institutions address their risk of loss only after the loan falls into a state of delinquency. Still others have no plans to address high-risk, current loans at all.

Because there is little focus on risk mitigation for current loans—as these homeowners typically pay and thus the servicer sees no need to contact them—the associated contact data get stale and the direct connection to the homeowner becomes lost.

Traditional primary loss-mitigation efforts have focused almost entirely on loans that have already hit the 30-plus-days delinquent stage. With the growing tendency of current loans going delinquent, loan owners are now being forced to focus on the entire loan life cycle in ways that include preventative loss-mitigation strategies prior to having ever missed a payment.

Most banks have addressed the problem by using a brute-force approach: simply increasing throughput by hiring armies of staff. Not only is this expensive, but it also exacerbates problems by heaping too many bodies onto an already broken support system.

Other banks are stepping back and taking a more sophisticated approach by revamping their entire process in key areas such as contact data, outreach methods and customer service. The benefits realized are surprising and have shown stark improvements not only in contact effectiveness and loan efficiency, but more importantly in the cost of servicing and in overall loss recoveries.

Using borrower incentive programs to fight default

One example that epitomizes this movement to innovation and increasingly valuable solutions is an incentive-based program that allows banks, funds and even mortgage insurers to (among other things) forge a new and different connection with their borrowers.

Incentive-based programs are beginning to gain momentum as an inexpensive and effective way to proactively address strategic default. The PMI Group Inc., Walnut Creek, California, a leading private mortgage insurer, recently launched the Responsible Homeowner Reward® (RH Reward) program, fully administered by Loan Value Group, to support sustainable homeownership in certain hard-hit real estate markets. The program targets underwater homeowners by offering both cash and non-cash incentives to stay current on their mortgage.

Since the launch of the RH Reward program in January 2010, the program has produced right-party contact data lifts of 40 percent to 60 percent and program conversion rates (the number of borrowers who enroll in a program divided by the number of direct contacts) of more than 90 percent. In doing so, it has dramatically increased the risk owners' ability to connect and stay engaged with their borrowers.

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Once a homeowner becomes enrolled in the program, modern outreach methods for communicating with the homeowner—including email, Web and social media networks—provide a non-invasive way to communicate with the borrower and gather additional information. High-risk loans are addressed immediately by placing the homeowner in a workout strategy at the first sign of trouble—which, in many cases, is before a payment has been missed.

To date, 76 percent of delinquent homeowners in the program have transitioned into successful loss-mitigation or recovery plans within 30 days of the first signs of distress.

The program has also revealed that 83 percent of electronic communications to the homeowner are regularly being accessed, with more than 55 percent providing continual contact data "refreshes" throughout the life of the relationship. Maintaining a constant, positive connection with the homeowner has played a significant role in the performance of "incentive-enhanced" pools.

How the program works

The Responsible Homeowner Reward program is a private-label, outsourced, variable-cost rewards platform designed to promote timely and consistent payment behavior on underwater loans. Its simple, patented design provides for a cash (or non-cash) reward contingent on repayment of the mortgage. The reward can also be used as a credit toward refinance or sale.

Built on a foundation of behavioral economics, incentive theory and consumer marketing, the RH Reward is designed to reward borrowers for staying (or becoming) current on their mortgage obligation. This program provides a much better alternative to a principal reduction for banks, and can be executed in scale without placing additional operational burden on the servicer.

The secret behind the success of the program lies in its unique ability to make homeowners understand that their lost equity has been replaced and that their good payment behavior will ultimately be rewarded.

To date, there are just under 10,000 homeowners enrolled in the RH Reward program, with approximately 50 percent coming from Florida, Michigan, California, Nevada, Ohio, Illinois and Arizona. The financial institutions offering the program are experiencing 50 percent lower default rates than related control groups in some of the hardest-hit parts of the country. Figures 1 and 2 highlight delinquency performance as well as loan characteristics for both first and second liens that are part of the program.

The blend of upbeat messaging, an alignment of interests and a credible, ongoing connection combine for permanent change for the better in the mind of the homeowner.

The simple fact remains that a borrower buys a home for only two reasons: shelter and investment. Additionally, the past four years have seen both a significant and historic decline in home prices as well as a record number of vacant homes available. Consequently, when the investment has disappeared and their shelter can be cheaply recreated, homeowners are left with a tremendous feeling of loss and hopelessness that has led to a rise in strategic defaults.

Once a borrower has fallen into delinquent status, the probability of a long and drawn-out foreclosure (or modification) process is high.

This psychological state of homeowner despair can be addressed via a new connection with the homeowner. This new connection doesn't address the mortgage, the debt or the homeowner's negative situation, but rather the positive characteristics associated with timely aid in the form of a new asset and the "re-equification" of the subject property.

To date, the Responsible Homeowner Reward program has succeeded in lowering annual delinquency rates and increased prepay speed through cash-in refinancings, as shown in Figures 1 and 2. What's more, homeowners, who subsequently fall delinquent tend to cure at a much faster rate due to the positive connection established during the program's outreach and enrollment cycle.

Lastly, when the delinquent homeowner's delinquency situation becomes "irreversible" (due to job loss, relocation, etc.), resolution timelines have been cut by more than 75 percent. This is largely the result of regularly updated contact information, a previous positive borrower experience and a connection forged as a result of a proactive outreach strategy.

Evidence of borrower acceptance

Even in the early stages of outreach and enrollment, the program showed signs of widespread borrower acceptance. For example, during a telephone/email outreach campaign launched in the third quarter of 2010 by a large national lender, it was determined that nearly 40 percent of borrower contact data was inaccurate or missing (email, phone numbers, etc.). Surprisingly, when the homeowners were notified of their selection for the program a few days later by traditional mail, the homeowners reached out to the RH Reward call center to review the offering and enroll in the program.

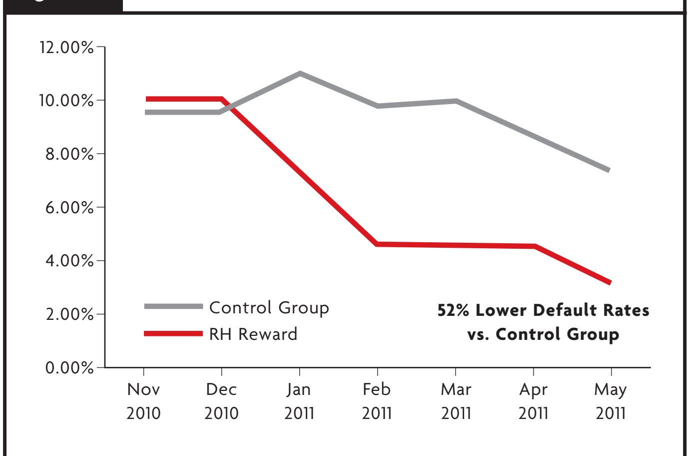
At that time, the homeowners proceeded to update and append their existing contact data, including cell phone numbers, work numbers and multiple email addresses. The campaign ended with the highest reported conversion rate of any program in the bank's history—nearly 97 percent.

Much like frequent-flyer miles and reward points, the homeowner will go to great lengths to maintain equity that was "earned" or granted.

The problem of bad contact information

By comparison, champion/challenger programs utilizing traditional servicer methodologies for loss mitigation show glaring deficiencies. Once a borrower has fallen into delinquent status, the probability of a long and drawn-out foreclosure (or modification) process is high. In fact, in "Dimensioning the Housing Crisis," an article by Laurie Goodman, senior managing director with Amherst Securities LP, New York, in the May/June 2010 issue of *Financial Analysts Journal,* reports that studies have shown that a homeowner who is more than 60 days delinquent has less than a 10 percent chance of becoming current.

Figure **1** **First Lien Default Rates**



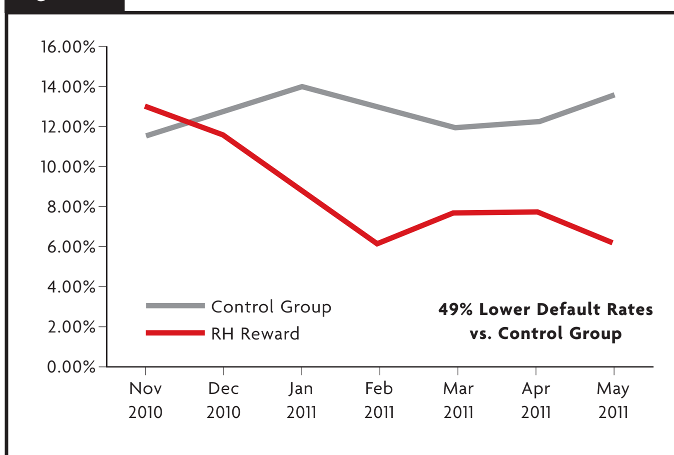
Average unpaid principal balance (UPB): $293,000

Average combined-loan-to-value (CLTV) ratio: 164%

Property location: California (29%), Michigan (23%), Florida (11%), Ohio (10%), Arizona (8%), Nevada (6%)

SOURCE: LOAN VALUE GROUP LLC

Figure **2** **Second Lien Default Rates**



Average UPB: $39,000

Average CLTV: 205%

Property location: Michigan (26%), Florida (18%), California (13%), Nevada (11%), Ohio (11%), Arizona (7%), Georgia (5%)

SOURCE: LOAN VALUE GROUP LLC

What's more, the time and money being spent by financial institutions during these failed recovery efforts are an expensive drain on valuable resources. Typically, more than 25 percent of a sample pool's borrower contact information from homeowners who are current on their mortgage obligation is inaccurate. This means that the risk owner has no reliable method to immediately contact the homeowner in the event of a missed payment.

It is no longer sufficient for servicers to merely send a monthly paper statement or make an occasional call to the homeowner.

Consequently, risk owners must scramble to make contact using methods such as rapid skip-tracing, robo-calling and door knockers that have limited success. Even when successful contact is made with the homeowner to offer a resolution, it is at best 60 days after the payment was missed.

In fact, the overall time needed to achieve a successful loss-mitigation outcome can be as long as 150 days, during which time cash flows are lost—or at least disrupted. Moreover, only 30 percent to 40 percent of those homeowners are actually ever contacted, and of those, only 18 percent to 28 percent successfully complete the workout materials.

A more modern approach

The secret behind the success of mortgage incentive strategies points less toward traditional loss-mitigation and recovery methodologies and more toward an approach that carefully combines behavioral economics, incentive theory and consumer marketing. A simple carrot-and-stick strategy will not suffice in these situations.

Most residential servicing platforms are old, outdated and unable to handle the infrastructure burden the current crisis has placed on many servicing organizations. Moreover, nearly every loss-mitigation or loss-prevention strategy fails to address the single greatest cause of mortgage default in the United States—negative equity.

Understanding borrower behavior and the homeowner's response to his or her lost equity, a struggling economy and a misalignment of interests all play a key role in establishing both a permanent, positive homeowner connection and an affirmative path toward future resolution.

From a connectivity and behavioral standpoint, there is one particular phenomenon that is a key differentiator between traditional loss-mitigation methods and successful incentive strategies—salience. In today's environment, it is paramount to actively manage the relationship with the homeowner. When you manage the relationship, you manage your risk.

It is no longer sufficient for servicers to merely send a monthly paper statement or make an occasional call to the homeowner. With advances and mass adoption of mobile computing devices (e.g., BlackBerry®, iPhone®), there are unlimited opportunities for increased saliency, connectivity and an ongoing positive connection with the homeowner.

Reward-incentive strategies rely on making new information easily accessible and highly visible to the homeowner through a multitude of channels. By leveraging an array of channels—including direct mail, phone, email, Web, short message service (SMS), Internet voicemail (IVM) and social networks—the likelihood of reaching the homeowner with a positive message and maintaining connectivity is dramatically increased.

Furthermore, by crafting a clever direct-marketing strategy that sequences those communications, homeowners can be gently prompted and not bombarded by unwanted or unpleasant messages from their financial institution typically associated with debt collection.

Once a reliable, positive homeowner connection is made, there exists a much greater opportunity to obtain updated borrower and property information on a more regular basis. Finally, this message is most successful when delivered in a manner consistent with the borrower's profile, payment history, geographic region and market conditions.

Tailoring the solution to the problem

Connectivity and incentive strategies also produce a number of other fringe benefits by providing an early-warning system of sorts to financial institutions regarding borrowers who are or may be planning to default.

A re-emerging concern for banks from the recent double-dip in housing is how to address the growing problem of strategic default. Understanding strategic default and borrower behavior is crucial.

For example, the motivations behind the pure strategic defaulter and the strategic defaulter, who is considered a "cash-flow manager," are as different as night and day. A pure strategic defaulter will default on only his or her mortgage and not default or even skip a payment on any other debt obligations. A cash-flow manager will ultimately default on his or her mortgage, but will struggle with all other monthly payments as well. The main different between the two is that the cash-flow manager has affordability issues as well as negative-equity issues but the pure defaulter usually has the means to pay. The motivation of the pure defaulter is almost exclusively a business decision, while the motivation of the cash-flow manager is similar to a homeowner struggling with monthly payments.

As a result, the size, structure and delivery methodologies of incentive strategies must address this difference.

When combining a payment modification with an incentive strategy (versus a principal reduction), the lender or servicer must use the information gathered during the connectivity phase to construct the optimal solution. The strategic defaulter's concern is lost equity and not necessarily a lower payment.

Anticipating the homeowner's perceived reaction to myriad loss-mitigation options will go a long way in creating borrower options that benefit both the homeowner and the shareholder. Unless the homeowner's negative equity is addressed during the modification process, the loan is more likely to experience a high re-default rate.

Additionally, when a homeowner first becomes delinquent, a properly structured, highly credible, cleverly presented incentive can actually drive the borrower to proactively reach back out to the servicer to enquire about that incentive and what the homeowner needs to do to keep it or apply it elsewhere.

Obtaining updated contact information directly from the homeowner—such as employment status, contact information, reasons for missed payments or the homeowner's intent to remain in the home—is not only more reliable, but helps the servicer apply effective loss-mitigation strategies quickly and more accurately. Establishing a positive connection with a credible incentive can also help dramatically shorten the timeline to a long-term resolution.

Finally, an incentive strategy that steers clear of moral hazard and fraud is much more likely to be offered by a financial institution in scale, and ultimately succeed with those homeowners who are predisposed to perform.

Forging a borrower connection is key

The future benefits that come from having a reliable connection with homeowners are becoming clear. Not only are risk owners able to quickly address delinquencies, they also have the ability to obtain real-time information directly from the homeowner. Proper connectivity is not limited to addressing delinquency, but provides a proactive way to collect helpful information or offer new products, programs, offerings and strategies.

Having the ability to periodically prompt the homeowner for valuable information such as current employment status or a change in contact information can provide intelligence that can help make more informed and smarter risk decisions.

In the midst of the current regulatory environment, one can also envision a world where servicers utilize this "new" connection to transmit/exchange information that can ensure compliance with federal mandates. The single-point-of-contact concept may seem daunting to some. However, with a simple alignment of interest and the proper balance of technology, marketing and consumer behavior, a new standard of homeowner and servicer cohesiveness can emerge.

Banks and other owners of risk are only now beginning to scratch the surface in realizing the power of homeowner connectivity and how useful this information can be in shaping existing and future businesses. **MB**

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