TAMING THE SUB-PRIME ANIMAL - JULY '97

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Here's How to Prepare for the B & C Market

Once upon a time, B & C (or sub-prime) loans were a niche market. The entities who originated it were looked down on by the mainstream originators. B&C lenders were to the mortgage industry what TV tabloids are to true journalism. The shops that serviced this product were also outside of the mainstream. Most of us who grew up in the world of agency quality servicing never had to sully our hands with a B & C loan.

Well, the times they are a changing. The B&C segment of the mortgaging industry has continued to grow at an unprecedented pace. Industry analysts project B & C originations at $190 billion in 1997 and $240 billion by 2000. Conventional lenders are entering into the sub-prime market through partnering with existing B&C operations or starting up their own operations. This is big business and everyone wants in on it.

The moral to this story is: If you're in the default servicing business and plan on staying in it, you had better know how to service sub-prime loans.
This article won't make you an expert. However, I will attempt to give the basics and teach you the proverbial "just enough to be dangerous."

Borrower Profiled

The sub-prime borrower is typically 42 to 47 years of age with a job history of seven to nine years. Incidence of self employment is much higher than with a prime borrower. Sub-prime borrowers have 9 to 13 years of home ownership under their belts. Just two years ago, they probably qualified for an agency quality loan. You'll find financial crises in their past, high debt-to-income ratios, poor financial planning, and poor bill paying habits. The sub-prime mortgagor would be termed an "experienced borrower."

These facts drive the portfolio characteristics. The rates and margins are higher than prime originations, although heavy market competition threatens to reduce this spread. Default frequencies are accelerated, occurring earlier in the life of the loan. Overall delinquency ratios run three to five times higher than a prime portfolio and the cure rate is lower. Incidents of default on payment of taxes and insurance exceed those on prime by multiples of two or three. Loss severity is greater than prime. Frequently, this is due to the property value being overstated at origination to create an imaginary equity cushion.

The cost of servicing is very high. If you are quite sophisticated, use available technology in the servicing of your sub-prime portfolio, spend a great deal of time on analysis, and do the best job possible, the cost will be 35-50% higher than servicing prime. If you've not quite mastered the sub-prime servicing puzzle, costs could be double that of prime.

A comprehensive sub-prime servicing program includes special consideration in the following areas:
Technology and Automation
Delinquency Prediction and Analysis
Hiring and Training
Specialized Procedures and Tactics
Cost Control
Loss Mitigation

DX-100

Technology Needed
Cost effective servicing requires a top flight servicing system that allows management to project control over the entire portfolio. It must schedule (if appropriate) and track activities in all areas of servicing, identifying exceptions to management almost before they happen. The productivity, effectiveness, and timeliness of the front line processors should also be monitored and reported by the system.

A Predictive Dialer is standard issue for the cost effective sub-prime collection operation. The resulting increase in production of outgoing phone calls is 200-400%. Automated interfaces to on-line phone directory providers is a desirable feature, along with automated letter generation based on call results. Western Union's "Quick Collect" and the "Speed Pay" systems are more standard issue items.

A properly installed, programed, and scripted Voice Response Unit (VRU) will also help control costs by handling 10-40% of incoming customer calls.

Delinquency Prediction and Analysis
The importance of portfolio and delinquency analysis cannot be overemphasized in a sub-prime environment. In a sub-prime portfolio, it's typical to see 70-80% of the delinquencies consistently coming from the same 20-30% of the portfolio. Directing collection efforts based on default probabilities translates into substantial savings and a more effective program because the efforts are directed where they are needed.

Another important tool is the credit score. It should be captured at origination and updated frequently. Deterioration of a score is a great predictor of future collection problems. Studies show that a borrower who is originated with a score of 750 but later drops to 650 is ten times more likely to default than a borrower who was originated with a score of 650 and remained at a score of 650. If you don't have the experience to create your own delinquency prediction model, look into packages such as Freddie Mac's Early Indicator.

Hiring and Training
Remember that the sub-prime borrower tends to be "experienced." Unfortunately, this frequently translates into being experienced at avoiding timely bill payments. Throwing inexperienced or untrained collectors at this type of borrower would be the same as bear hunting with a toothpick. This job requires journeymen collectors with a high level of experience&emdash;not loud mouthed phone jockeys, but seasoned professionals with the ability to focus on multiple objectives.

Low unemployment, however, has made it difficult to find experienced collectors in many markets. In that case, hire the brightest possible individuals and give them comprehensive training. By the way, you won't hire this type of individual cheap.

Adapt Tactics to Market
It's been frequently stated that a single entity cannot successfully be a prime and sub-prime servicer. This is due to the fact that these products don't perform alike or respond to the same stimuli. Threatening a sub-prime borrower with a bad credit report might evoke a response of laughter. After all, having a few 30- and 60-day delinquencies on the borrower's report didn't stop the borrower from qualifying for this loan. On the other hand, treating the prime borrower like a sub-prime borrower could also cause a problem. Calling the Reverend Dawkins at his

place of employment at 11:00 a.m. on Sunday morning the first time he's 20 days late after five years of on-time payments could result in a pretty ugly complaint. To successfully service sub-prime, you must institute a clearly defined sub-prime program.

Make Program Aggressive

Sub-prime loans have a very high incidence of default and high severity of loss. This makes an aggressive Loss Mitigation program essential. All staff members must be trained to keep their ears open for loss mitigation prospects during the delinquency servicing process. While the general default staff are constantly seeking loss mitigation prospects, a separate loss mitigation department must be charged with the task of seeing the deals through to completion. They should also analyze the portfolio of delinquent loans and solicit for potential workout candidates.

Do Control Costs

Just because you've accepted the fact that sub-prime loans are more expensive to service, don't go overboard. Because of their high servicing costs, cost control is extremely important. Use outsourcing solutions to get past temporary increases in work load. Don't be afraid to use outsourcing as a long term solution when clearly cost effective.

Remember, sub-prime loans are different from prime loans and must be treated as such. The costs are high but so are the profits. And even if you can't fathom the idea of being a sub-prime servicer, chances are you can't escape.

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