The Right Way to Underwrite
Fending Off Foreclosure with the Four Cs

Credit. Capacity. Collateral. Character. The mortgage lending industry has traditionally focused on these “Four Cs” when underwriting residential loan applications, recognizing that a thorough evaluation of these characteristics is the foundation for mortgage transaction risk management. By definition, when a foreclosure occurs, there is a failure at some level. As easy as it is to blame only the borrower for defaulting on the contract to repay, there has been an undeniable drop in the diligence of underwriting professionals to anticipate risks based on the time-honored principles associated with the Four Cs.

What’s Been Happening
The unbalanced approach taken over the last two decades to evaluate these four factors has produced some very negative consequences. Servicers are being forced to reconsider their methodology as they contemplate the impact of increasing loan failures on their financial statements.

Prior to 1985, character and collateral were the dominant driving factors in underwriting. Operations were decentralized, with underwriting taking place in branch offices. Credit ratings and scorecards were still in their infancy. Credit officers knew their customers at some level, and they knew the properties, or at least the neighborhoods, where the loans were placed. Sometimes, loan servicing and collections were carried out by the originating officers or by their supporting staff.

Automation Favors Credit and Capacity
During the 1990s, progress in the use of information technology began to change the way the mortgage industry did business. Automation and centralization became the new buzzwords, and desktop underwriting software replaced methods that required more individualized input.

Credit bureaus became efficient at data gathering and reporting. Branches no longer controlled applications, underwriting, or collections, as these functions became centralized. The explosion of the influence of the secondary markets further removed lenders from responsibility for loan performance.

Secondary markets began to look for a standard underwriting process that could be measured, easily described, and compared to the processes of other lenders. There are many more measurable variables attached to credit and...
THE FOUR Cs
CREDIT
CAPACITY
COLLATERAL
CHARACTER
capacity than to collateral and character. All scorecards built in the 1990s revolved around just the first two of the Cs. Performance analyses became focused on the first 12 to 15 months of the life of a loan because most loans are sold in the secondary market during the first year. Lenders became less concerned about loan performance data beyond the sale of the paper.

Measuring and evaluating the collateral was simple. As long as approved appraisal standards were followed, whatever the appraisal valuation concluded was perfectly acceptable. Review decisions were based on checklists and gut instinct, and very few deals were challenged. Even fewer were rejected because there was little or no feedback built into the evaluation process from outside sources knowledgeable about the property or its area. As the face-to-face experience of the borrower with the underwriting professional was eliminated, borrower character was no longer understood or measured; in subtle ways, the obligation to repay was not reinforced. When an organization was hit by fraud, certain corrective processes were implemented, but with widely varying levels of effectiveness.

Resurgence of Collateral, Character as Determinants

Since the turn of the millennium, the industry has learned that factoring collateral and character into the lending decision is both more complicated and more vital than previously thought. By tying servicing data back to origination data, it has been discovered that collateral and character actually drive approximately 70 percent of all losses in mortgage portfolios. Their influence affects early payment delinquency, roll percentages in collection management, foreclosure rates, and loss severity. While fraud-for-profit risk captures all the headlines, occupancy falsification affects a far greater number of loans. This deception has driven the negative numbers even higher over the past few years, a result of speculative investors taking advantage of relaxed underwriting rules to engage in a feeding frenzy in markets like Florida and California. When the rapidly escalating market cools, it is easy for these non-oc-

IN THE NEWS

MLS Operators Face FTC Charges

Two real estate groups operating multiple listing services in the Detroit, Michigan area are facing charges from the Federal Trade Commission that they illegally blocked competition by limiting consumers' ability to obtain low-cost real estate brokerage services.

The commission also said that it had reached consent agreements with five other groups operating multiple listing services in parts of Colorado, New Hampshire, New Jersey, Virginia, and Wisconsin that have discontinued the challenged conduct.

According to the FTC, all seven groups adopted rules that withheld valuable benefits of the multiple listing services they control from consumers who chose to enter into non-traditional listing contracts with real estate brokers. The FTC says that six of the seven blocked non-traditional, less-than-full-service listings from being transmitted by the MLS to popular Internet Web sites. According to the complaint, the seventh group went further, adopting policies that include blocking such non-traditional brokerage contracts from the MLS entirely.

“The rules these brokers made drove up costs and reduced choice for consumers, and they violated federal law,” said Jeffrey Schmidt, director of the FTC’s Bureau of Competition.

The FTC also charges that as a result of the policies, MLS members have been discouraged from offering or accepting exclusive agency listings or other kinds of non-traditional listing agreements, limiting their ability to provide consumers with unbundled brokerage services and making it harder to sell homes. The commission also contends that the Web site policies do not produce competitive efficiencies to balance their anticompetitive effects.

The two Michigan groups facing charges are Realcomp II, Ltd., and MIRealSource, Inc. Realcomp II is owned by several Realtor boards and associations, has more than 14,800 members, and provides services to more than 2,100 real estate brokerage offices in Southeastern Michigan. MIRealSource provides services to more than 840 real estate brokerage offices in Southeastern Michigan and has more than 7,000 members, according to the FTC.

“Meeting the criteria, the lender is, and we thought that’s how it’s going to work,” said MIRealSource’s director of the FTC’s Bureau of Competition. “The FTC also charges that as a result of the policies, MLS members have been discouraged from offering or accepting exclusive agency listings or other kinds of non-traditional listing agreements, limiting their ability to provide consumers with unbundled brokerage services and making it harder to sell homes. The commission also contends that the Web site policies do not produce competitive efficiencies to balance their anticompetitive effects.

The Michigan complaints will be heard by one or more administrative law judges at the commission, unless the charges are settled before the cases go to trial. The five groups that the FTC had issued complaints against and consent orders with are Real Estate Services, LLC, based in Loveland, Colorado; Northern New England Real Estate Network, Inc., which is based in Concord, New Hampshire; Williamsburg Area Association of Realtors, Inc., which is based in Williamsburg, Virginia; Realtors Association of Northeast Wisconsin, Inc., based in Appleton, Wisconsin; and Monmouth County Association of Realtors, Inc., which is based in Tinton Falls, New Jersey. All of the groups operate an MLS for hundreds of thousands of real estate professionals in their respective areas, according to the FTC.
cupant buyers to walk away from the properties because they are not "home."

The amount of actual equity in the property, the market risks surrounding the property, and the true intent of the borrower factored into scorecards and underwriting decisions and tracked with the same vigor as credit and capacity variables were in the 1990s. Collateral risk management companies have helped manage these new processes for long-term roll rates and loss explained significant variations in loss statistics. In fact, there is evidence that a FICO score should be reduced by as much as 50 points when collateral risk issues exist. Recent tests conducted in servicing looked at the potential benefits of using tools from traditional behavior scoring models. Once again, identity and collateral scoring explained significant variations to long-term roll rates and loss severity that behavior scoring failed to identify.

Clearly, it is imperative that character and collateral risk be are all conditions that influence the behavior of mortgage applicants. Independent studies have been conducted on millions of loan transactions with top lenders and secondary market firms to prove this. When traditional variables are held constant—such as FICO scores, LTV ratios, lien position, product purpose, product type, and term—the collateral scoring has a profound impact on loss statistics. In fact, there is evidence that a FICO score should be reduced by as much as 50 points when collateral risk issues exist. Recent tests conducted in servicing looked at the potential benefits of using tools from traditional behavior scoring models. Once again, identity and collateral scoring explained significant variations to long-term roll rates and loss severity that behavior scoring failed to identify.

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