

Financial Foresight

A look at the latest topics affecting banking, insurance, investment management and securities

Subprime Lending Market: Mitigating Risk in a Risky Business

Loans to consumers with questionable credit histories have always been a high-risk, high-reward business. But now the subprime lending market has taken a turn for the worse, as this volatile segment of consumer lending has experienced rapid increases in delinquencies, foreclosures, bankruptcies, and company failures over the past six to eight months.

Lenders, servicers and investors must be cognizant of the inherent risks -- financial, regulatory, credit and reputational -- that they face as participants in the subprime lending market and take appropriate steps to mitigate the negative impact that such risks can have on their subprime portfolios. Specifically, participants must understand:

- How the loss-forecasting process must address the changing subprime environment;
- What practices and processes they need to service higher delinquencies in subprime portfolios; and
- How the intricacies of relevant consumer protection laws and stricter regulations impact the management of subprime portfolios.

"We believe that despite all the news reports regarding deteriorating conditions witnessed in the subprime sector of the mortgage market, the worst is still to come," says Brenda White, Managing Director



with Deloitte & Touche Corporate Finance LLC. "The 2005 and 2006 vintages of subprime loans are performing worse than any other vintage, and they are defaulting at a higher rate than any other vintage."

Rising Defaults

Between 2001 and 2005 subprime originations grew from \$173 billion to \$665 billion, an average increase of 57% per year. For 2006, subprime share of total originations was about 23%. The cumulative default rate, as a percentage of origination balance, peaked between 37 and 45 months from origination. As 2005 and 2006 saw a significant jump in originations, a large share of the book of business must be less than two years old. Significant numbers of defaults from these vintages are yet to occur.

To counteract these adverse trends, lenders, servicers and investors need to re-evaluate their approach to subprime underwriting. They must consider:

- Employing decisioning models, fraud-detection tools and risk-based pricing strategies, and
- Incorporating recommended changes suggested by Federal Financial Institutions Examination Council's interagency guidelines.

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Most participants in the subprime lending market have begun to take steps to cope with the expected increase in defaults.

According to a recent online poll of some 130 subprime lenders, servicers and investors conducted by Deloitte & Touche LLP, 60% report that their organizations have changed their underwriting standards to address the expected increase in defaults. About half of these organizations took action more than three months ago.

Anecdotal evidence suggests that underwriting standards were loosened at a number of institutions during the 2004-2006, which is likely now contributing to increased default rates. As a result, it is a concern that 40% of the surveyed subprime lenders have not made any changes to their underwriting standards to address the expected increase in defaults.

The Fair-Lending Landscape

The subprime lending market is subject to a number of federal and state laws designed to ensure that loan applicants are treated fairly and without discrimination. These laws include the Fair Housing Act, the Equal Credit Opportunity Act, the Home Mortgage Disclosure Act, and the Community Reinvestment Act.

“When federal regulators issued guidance on non-traditional mortgage product risk, it was an early-warning signal to the mortgage industry,” says Curtis C. Johnson, Jr., a Senior Manager with Deloitte & Touche LLP’s (“Deloitte’s”) Regulatory Consulting Practice.

Although the focus of the guidance was on safety and soundness issues, the regulators indicated that they have some consumer protection concerns as well. In fact, one section of the guidance focuses specifically on communication with consumers. The guidance states that management should insure that consumers have sufficient information to clearly understand the loan terms and associated risks prior to making a product or payment choice.

Congress has also put lenders on notice that it has concerns in the fair-lending area, particularly lending practices in the subprime market. Senate Banking Committee hearings have warned subprime lenders that Congress will consider new standards to protect homeownership from predatory practices.

Senator Chris Dodd (D-Conn.) has called the current system out of balance, and he says that there is a chain of responsibility that makes predatory loans possible. He lists brokers, bankers, Wall Street, regulators, Congress and the administration as links in this chain. One of the things that Congress is considering in order to restore balance to the system is a suitability standard.

In addition to joining the other regulatory agencies in issuing the guidance for non-traditional mortgage products, the Federal Reserve System is revising Regulation Z disclosures to address its concerns regarding the lack of information being provided borrowers about use of non-traditional mortgage products.

Trends in Washington, D.C.

To promote the practice of providing consumers with sufficient information to clearly understand the loan terms and associated risks prior to their making a product or payment choice, the Federal Reserve is considering requiring more early disclosures as well as requiring worst-case explanations in more situations.

The U.S. Senate Committee on Banking, Housing and Urban Affairs recently held a hearing entitled, “Preserving the American Dream: Predatory Lending Practices in Home Foreclosures.” In his opening

statement, Senator Dodd said he welcomed the creation of the subprime market to the extent that it added to the pool of credit in a positive and constructive way -- that is, in a way that builds wealth. However, he believes that it is not enough simply to create home ownership -- home ownership must be sustained, preserved and protected as well.

To help accomplish this, Congress has attacked lending practices it believes are stripping equity from homeowners and leading to foreclosures. These practices include:

- Lenders that make stated-income loans when they know that the borrowers don't have income to qualify for the loan;
- Yield-spread premiums designed to increase broker profits rather than reduce closing costs, and
- Subprime loans targeted at minority borrowers, regardless of their financial health.

Recommended Practices

Lenders can expect increased scrutiny and enforcement actions from federal and state regulatory bodies over fair lending practices. As a result, they should review their compliance risk assessment process for their subprime lending business and ensure that they are adequately identifying and assessing compliance risks.

Moreover, lenders also need to ensure that their compliance risk management programs are effectively controlling and monitoring the compliance risks associated with subprime lending. In addition, they should:

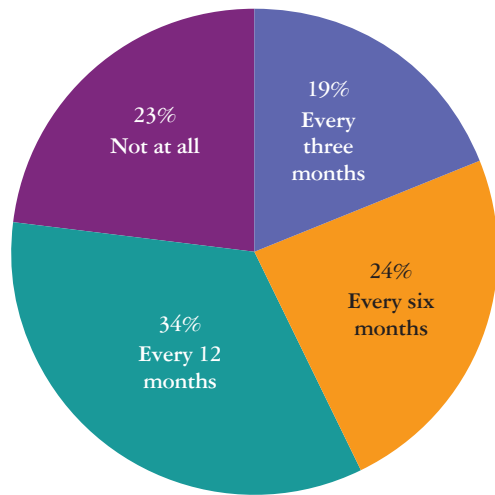
- Review the accuracy of their HMDA data and develop processes to make necessary corrections
- Perform a fair-lending self assessment focusing on pricing in subprime products and brokered loans
- Develop a comprehensive risk-based pricing policy to promote transparency and consistency
- Develop analytical techniques to assist in identifying potential discrimination



By taking these steps, lenders will be able to demonstrate to examiners that they have taken a proactive approach to fair lending compliance and have the ability to effectively identify, assess, control, and monitor risk in this area.

While most subprime lenders appear to be on top of their fair-lending practices, there are some significant exceptions. According to Deloitte & Touche's online poll, 77% of the surveyed companies say they review fair-lending compliance in their subprime portfolios at least annually; 43% do so at least every six months. At the same time, 23% say they do not review fair-lending compliance in their subprime portfolios at all.

Due to the recent increase in scrutiny by the Federal Regulators, how often do you review fair lending compliance in your subprime portfolio?



Loss Forecasting

As economic conditions deteriorate, loss forecasting becomes both more important and more challenging. "A sound loss forecasting process really is crucial during these uncertain times", says Niall Lynas, a Senior Manager with Deloitte's Capital Markets Practice. As loss reserve coverage ratios decline, allowances for loan and lease losses (ALLL) will come under more and more scrutiny. Additionally, many lenders are currently striving to develop or upgrade loss forecasting processes to comply with the Advanced Internal Ratings-Based standards discussed in the Basel II accord.

In addition to modeling losses for ALLL and Basel II, a sound loss forecasting process is needed for management reporting, portfolio valuation, and collections workflow modeling. And perhaps most importantly, it is essential for the appropriate pricing of risk in decisioning processes. Without accurate and timely forecasts, lenders run the risk of over-compensating for downturns in the economy by too aggressively tightening underwriting standards. Although specific requirements may vary across each of the uses listed above, the overall framework should be the same – as are the challenges associated with forecasting during shifting economic environments.

As Credit Risk managers and loss forecast modelers are acutely aware, there are many challenges to loss forecasting. But a particularly daunting one occurs when there is a lack of representative data. Unfortunately, statistical models can only ever be as good as the data on which they were developed. Given the current economic climate, historical data may not now be representative of the future – especially in mortgage lending. In the last few years we have seen loss rates that are much lower than historical norms, and if we look back prior to – say – 2002, many of the products that are common now (such

as option adjustable rate mortgages) were much less prevalent. Therefore, large portfolios of many of these "non-traditional" products have never been stressed under harsh conditions such as flat or negative house price growth.

While unfortunately there is no "silver bullet" – no statistical methodology or tool we can pull off the shelf to remedy this issue – there are a number of methodologies that lenders can take now to recalibrate models and reduce the risk of inaccurate loss forecasts. These include:

- Introducing additional segmentation by key risk drivers and new product types
- Completing a "reset analysis" to determine mortgage borrowers' capacity to pay when adjustable rate mortgages reset
- Using "early stage" performance reporting to identify adverse trends in new vintages.
- Selecting or weighting the time periods on which to train models by relevancy
- Using external benchmarks to assess performance of new products
- Using qualitative management adjustments (backed by sound reasoning and detailed documentation)

These methodologies should be put in the context of a formalized loss forecasting process, which includes documentation of policies and procedures, analysis of the internal and external business environments, data extraction and quality analysis, statistical modeling, and results compilation and documentation. In our experience, many lenders either rely too heavily on statistical models, or at the other end of the spectrum rely too heavily on management judgment without having supporting statistical analysis and segmentation. Of those polled, 25% believed their process needed to be more rigorous; and a further 41% said that although their models were fairly good, their process relied too heavily on models.

When employing loss forecasting, lenders are advised to be aware of the limitations of statistical models; test assumptions thoroughly and regularly; leverage segmentation and predictive metrics; use external benchmarks and early-stage reporting when new products are involved; and develop a comprehensive process that involves many areas of the business.

Predictive Tools for Collections

Historically it has been said that if borrowers have five bills to pay, and only have enough money to pay for three of them, they would be compelled to pay their mortgage first to avoid foreclosure. However, given the loosening of underwriting standards over the last few years (such as the proliferation of investor and stated income loans with high LTVs) as well as the large number of ARM's resetting, historical payment patterns may only provide limited guidance in the coming years. If the subprime market continues to deteriorate, collections will be an even more important component in managing the business efficiently.

"Many lenders have increased the efficiency and productivity of collections by migrating to a risk-based collection strategy," says Elizabeth Jordan, a Senior Manager with Deloitte's Capital Markets Practice. "Using predictive analytics provides an approach that aligns the collections organization by risk segment, streamlines the workflow, and measures collection performance accurately."

Predictive tools offer a variety of benefits:

- Behavioral scoring and decision engines analyze customer payment data to predict future payment behavior;
- Behavioral models determine the right treatment, at the right time, for the right cost;
- Alignment across the credit lifecycle creates the ability to monitor portfolio performance and loss forecasting to provide a feedback loop from collections to sales; and
- Leading institutions are able to capture benefits in dollars collected, reduced collection cost per dollar collected, call volumes, roll rates, charge offs, and other critical metrics.

Benefits reported by organizations who have rolled out risk based collections include:

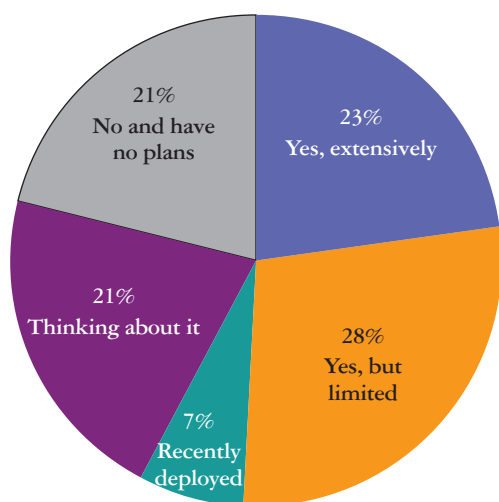
- Reduction in customer attrition by 10%, by eliminating calls and letters to those like to pay without contact
- Reduction of call volumes by 35 to 40%, making more efficient use of collections resources
- Improvements of dollars collected at risk by 20%
- Reductions of up to 30% in cost to collect \$1
- Roll rate declines of 15 to 20% in 30 to 60 days PD, as well as reduction in charge-offs by 10%

More than 80% of large U.S. banks today already employ some version of predictive analytics. They use past payment data to predict future behavior to perform such activities as identifying key customer segments, detecting fraud and determining the proper treatment strategy for past-due accounts based upon the risk category of the account.

Determining the proper treatment strategy must also be completed in light of the cost to collect dollars past due. For example, an increasingly important metric is the cost to collect one dollar. If this metric is not calculated and monitored, organizations risk deploying treatment strategies and collection solutions where the cost is excessive at a time they can least afford it, driving up overall operational costs.

Is your institution using predictive analytics in their collection operations?

According to Deloitte & Touche's poll, 58% of the surveyed companies are using predictive analysis in their collections operations. Another 21% are thinking about deploying this strategy and 21% more have no plans to do so.



Components of Success

Several characteristics are common among successful subprime lenders that employ a risk-based collections strategy:

- Operations are organized by high-, medium- and low-risk instead of number of days past due;
- The operational structure is consistent across all locations, whether in-house or outsourced;
- The treatment strategy is based on what approach will best recover dollars at risk;
- Collections processes move from reactive to proactive loss containment; and
- There is greater accuracy to measure costs of collections by risk profile of accounts.

To improve collections performance, metrics need to move beyond number of calls to promises taken and promises kept surrounding dollars at risk. The cost to collect one dollar is the prime metric that needs to be widely adopted. Institutions should implement fully automated account queuing, fully automated correspondence, and real-time data on account aging.

Deploying risk based collections takes time and effort and it can be challenging to stay the course. So what can lenders do in the next 30 to 60 days to address the potential delinquencies and foreclosure losses. Well, one idea is to develop pre-emptive offers before ARMs actually reset. They can evaluate the accounts based on credit risk and their potential to become delinquent and develop offers assessing the cost versus profitability of the account based on pre-collections activity. Another idea would be to develop alternate treatment strategies and deploy them on a smaller segment of delinquent accounts based on say product type or geography; and then assess the effectiveness of the champion/challenger treatment strategies.

Such an approach requires a technology infrastructure that combines a customized treatment strategy with minimal manual intervention; this increases dollars collected and decreases costs. Such a risk-based collections technology infrastructure would include data-mining tools, workflow-management tools, rules-based decisioning, predictive dialers, and a portfolio management dashboard.

Revisiting the Valuation Process

The impact of changes and shifts in defaults and prepayments of subprime loans show up in a variety of different securitized interests.

"The default curve historically for subprime loans has peaked between 18 and 36 months," says Jeff Green, a Principal with Deloitte's Capital Markets Practice. "Given some of the performance data that is emerging on the 2005 and 2006 books of origination, there's pretty strong evidence that defaults are manifesting themselves earlier. Subprime lenders with models predicting defaults based on data sets from the mid-1990s or even the late 1990s will need to revise their models to reflect the structural changes taking place today."

In today's economic environment, subprime lenders, servicers and investors face several known areas of concern:

- **Prepayments.** It has long been assumed that subprime loans are not very sensitive to prepayment. However, there appears to be some emerging sensitivity in light of home price

appreciation. As the subprime market has started to cool off in terms of appreciation, prepayment rates and default rates differ markedly for loans on homes with significant appreciation since origination as opposed to those with little to no appreciation since origination.

- **Severities.** Most of the models that subprime lenders use were created at a time when home price appreciation was fairly robust. These models may not work as well when home prices are declining.
- **Lags in recovery of liquidations.** Whereas it used to take an average of six to nine months between foreclosure to auction and recovery, it is now taking longer -- in some cases, as long as 18 to 22 months to recover funds.
- **Discount rates.** There's broad inconsistency across investors in terms of the discount rates being used for various asset classes. As accounts started to chase yield, various products, discount rates have drifted down into 10% to 12% range from the more traditional 15% to 18%. Today, discount rates are rising back up even higher, to as much as 18% to 20%, depending upon the tranche selected.

In addition, subprime lenders, servicers and investors face two emerging areas of concern:

- **Home price appreciation.** While this has probably the most universally used data set in estimation models, the question

has become what level of aggregation should subprime lenders use in their analysis? Most organizations employ MSA-level data, while some are beginning to drill down to ZIP-code levels.

- **Third-party loan-level data.** Analytical platforms and their calculators are increasingly moving from the use of "rep lines," where representative strata are created from loan information, to the use of loan-level characteristics. It is important for subprime lenders and investors to know the implicit assumptions that are made in the various models and the techniques that are used when these parameters are estimated.

Many lenders have seen rapidly increasing default volumes and losses in subprime lending. Clearly this trend will continue for some time. Enhanced regulatory and legislative scrutiny also will continue, and participants in the sector should monitor their practices closely because the legislators and regulators will be watching closely.

Loss forecasting can be especially challenging in this environment, impacting many areas of subprime lending and tools should be deployed to improve forecasting in the current climate. Moreover, as the focus in the subprime lending market has shifted from capturing market share to reducing losses, organizations should consider techniques to proactively manage subprime credit from cradle to grave.



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Note: Answers reflect views of more than 130 financial institutions participating in a webcast poll conducted on February 23, 2007.

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