SERVICING MANAGEMENT®

Reprinted with permission from the October 2004 issue

How To Deal With Scratch & Dent

While some scratch and dent loans may be current and making their monthly payments, they still present a unique set of servicing challenges.

BY CHARLIE HODGE

With the current interest-rate environment causing a slowing of the refinancing boom, and with more originators entering the world of subprime lending, many bankers are sure to find themselves stuck with a few loans that they are unable to sell to their primary investor base.

Hodge

Some originators, many constrained by their liquidity needs, sell such loans immediately, often at a slight discount, depending on the nature of the scratch and the severity of the dent. They recoup their original capital as quickly as possible in an effort to re-lend it again, thus allowing the lending/earning cycle to continue.

Others, perhaps those with larger balance sheets and more free cash flow, have the luxury of finding themselves at the crossroads of trying to decide if they are better off keeping their scratch and dent loans or selling them in the secondary market.

Scratch and dent loans usually have fallen out of a sale or have been required to be repurchased. The list of issues is long and can range from something as simple as a missed ratio or guideline to more serious problems, such as first-payment defaults, valuation discrepancies or even fraud. An obvious, albeit common, problem is a volatile interest-rate environment moving in the wrong direction. Any one of these issues is capable of rearing its ugly head and tainting your loan as scratched and dented.

The decision to balance-sheet these loans or sell them can be a complicated one. On the surface, no banker wants to take a loss on a loan that they believe should have sold for par or better. Why sell a current loan that fell out of a bulk sale due to a missed FICO score, maybe at a discount, when it has made its last 10 payments on time?

Alternatively, what is the rush to sell a non-performing, 80% LTV loan when the foreclosure sale is set for a month from now?

The answer to such questions would obviously depend on several factors, including the nature of the loan's problem, the equity position or LTV, your warehouse line's leniency for aged, sub- or non-performing loans, and especially the company's overall cash needs. However, what is often haphazardly overlooked when deciding whether or not to retain scratch and dent loans are the multitude of servicing challenges that will undoubtedly arise.

Hold too long

A common, yet critical, servicing mistake is to hold on to scratch and dent loans for too long, hoping that the situation will mysteriously go away on its own. This logic is similar to the argument used by buyers of many failed Internet stocks during the tech bubble in early 2000. A large number of these investors made the decision not to sell, even though the first signs of trouble were loud and clear. They had the chance to get out with only a small loss, or perhaps with less of a profit. But they kept thinking it was going to rebound, if they just could hold on a little longer.

The important lesson learned then was that the return *of* capital is far more important than the return *on* capital. This simple axiom holds true when deciding if you should sell your scratch and dent loans.

While some scratch and dent loans may be current and making their monthly payments, they still present a unique set of servicing challenges. Often, the borrower might be prone to significantly higher delinquency rates, necessitating very close monitoring.

For instance, you may have found yourself to be the proud owner of a 100% LTV, uninsured FHA loan. It may be making its payments on time, but there clearly is a higher level of risk inherent in the situation that demands a very watchful eye and close contact with the borrower.

As such, it may be in your best interest to compare the cost of selling such a loan versus retaining and servicing it for the long term.

For performing loans, the obvious options to compare are:

Charlie Hodge is a regional acquisition and servicing manager for Hunt Valley, Md.-based Empire Mortgage, a privately owned firm specializing in acquiring and servicing residential and mixed-use mortgage pools, including scratch and dent loans. He can be reached at charlieh@empmtg.com.

■ attempting to re-write the loan,
■ keeping the loan or
■ selling the loan.

Re-writing the loan necessitates having the available liquidity to hold it for a while, as it might take some time to close the new loan. Additionally, the borrower might be reluctant or even unwilling to re-close the loan, leaving you with one fewer exit strategy.

The decision to keep the loan on your balance sheet and service it is accompanied by other factors, such as the interest expense incurred to carry the loan on your warehouse line, the company's short-term cash needs, default risk and interest-rate risk.

Return of capital

Selling the loan quickly and decisively allows you to recoup the lion share of your principal, leaving you free to originate more loans - again, the return of capital versus the return on capital.

For example, assume the following hypothetical scenario: You are an originator with a $5 million warehouse line, and you are able to turn the line 2.5 times per month, resulting in a monthly origination volume of about $12.5 million. Assume you have $300,000 in dented loans, which implies that you have $750,000 per month ($300,000 times 2.5 turns) that you will not be able to originate, if your cash flow is tight. The front- and back-end fees on $750,000 might be two points, or potentially lost income of $15,000. Selling your dented loans at 99% provides you the opportunity to net $9,000 ($15,000, less the point on the dented loans) in income that you otherwise would not have been able to earn.

If servicing scratch and dent performing loans is a bit challenging and requires a specific skill set, then it could not be more true than when it comes to servicing sub-performing, re-performing and non-performing loans.

This list of servicing challenges is lengthy and includes such items as:

■ negotiating pre-foreclosure short sales,
■ ensuring that your current second lien position does not get foreclosed out by a third-party delinquent first lien,
■ avoiding tax foreclosure sales and unpaid hazard insurance,
■ preparing PMI claims (identifying and tracking claimable items),
■ executing deeds in lieu,
■ drafting loan modifications and written forbearance agreements,
■ monitoring verbal repayment plans,
■ correcting title issues,
■ monitoring foreclosure actions, and
■ spending valuable time educating the borrower.

Sub-performing and non-performing scratch and dent loans, to be serviced successfully, require an immense amount of dialogue with the borrower - often quite technical and time-consuming conversations - in an effort to help the borrower understand what their options are and the steps they need to follow to avoid foreclosure.

In order for that dialogue to take place, the loan servicing staff must first be knowledgeable about what those options are. Second, they must understand when certain options are applicable and when they are not. Trying to modify a 125% LTV loan probably does not make sense, given that you're essentially throwing good money after bad money, as well as into an unsecured position.

And if you do modify a loan, should you send it out for recording, or will you risk potentially subordinating yourself? Who can and cannot sign the agreement? Such complexities dramatically increase when dealing with first and second liens, divorce situations (who is on the note versus who is on the title), and bankruptcy and foreclosure proceedings within the myriad of state and county laws. Again, this is all very time-consuming, technical work that demands experience.

Plan ahead

If you decide to sell your scratch and dent loans, planning ahead will prove to be the most critical step, especially for the smaller players hoping to navigate around any potential cash flow troubles. If well-prepared, you will be less likely to get involved with a poorly funded buyer that can't close the deal in a timely manner, or an unscrupulous broker who misrepresents himself as a direct portfolio buyer. Good preparation will result in stronger execution by saving both time and money.

Once you have identified a handful of scratch and dent buyers, it is important to get to know them and their individual processes and requirements. This will help you know in advance what information each of them requires in order for them to bid your loans accurately, as well as to fund and close the deal quickly.

Essentially, you will need to compile the necessary loan data into a format that can be easily distributed and reviewed. Excel spreadsheets work great in this situation.

The tape should include, at a minimum, the following data:

■ current unpaid principal balance,
■ next due date,
■ interest rate,
■ fixed or adjustable,
■ margin and index (if adjustable),
■ lien position,
■ type of property,
■ the city and state the property is located in,
■ origination value or updated BPO value,
■ insurance information, and
■ origination or updated FICO score.

Once the tape is completed and the necessary data is reviewed for accuracy, e-mail the tape out to your various contacts, making sure that you clearly set a bid deadline (three to five days is enough time). Setting this deadline will help to facilitate timely execution and make your job easier.

Receiving bids

You should expect to receive indicative bids from your potential buyers, which is a strong indication of what the interested buyer is willing to pay, based on what was represented - stopping short of providing any type of commitment.

Once an indicative bid has been verbally accepted, a bid letter is prepared and signed by both parties. The bid letter identifies the pool of loans to be sold and the indicative price that was quoted.

For most scratch and dent buyers, due diligence consists of the buyer ordering a BPO on the loan, pulling an updated credit report, and performing a thorough review of both the origination files and the servicing files.

Upon completion of the due diligence process, the buyer and seller will review any potential changes to the final price. Items such as valuation, pay history or material credit deterioration may play a role in any repricing that may occur. Clearly, the more accurate the data is on the original tape, the more accurate the final pricing will be.

Once the final price is negotiated, a funding date can be established and a loan sale agreement executed between the two parties. Typically, 20 to 30 days is required to complete due diligence and fund the loans.

Many originators do not have an adequately sophisticated servicing department to handle the special challenges of delinquent or non-performing loans. Keeping your scratch and dent loans presupposes that your servicing department has the knowledge, experience and time required to service them effectively.

Servicing needs to be aggressive and swift, with decisive corrective action taken immediately. Your servicing department is the back door to your business, where dollars can quickly and quietly exit the building in the form of write-offs, protective advances, short sales, REO sales and even legal bills. SM