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Using Incentives To Positively Influence Payment Behavior

Forget the carrot and the stick – today's market requires a different approach to encourage borrowers to keep up with their loan payments.

By Frank T. Pallotta

For as long as the phrase "payment due" has been around, financial incentives have been necessary. In fact, most financial institutions use incentives in an attempt to lure consumers to their product long before the loan is even originated. Lower fees, rewards points, mileage programs, discounts and coupons are just a few of the many enticements used by credit card providers, second-lien suppliers and auto finance companies to attract the consumer.

How are incentives determined? Traditionally, the less "collateralized" the asset, the more important the idea of incentives will become. In fact, when the ability to secure the asset dwindles and the asset has lost value, the lender's desire to keep the consumer current becomes critical.

The residential mortgage industry, however, is quite different. Offering competitive rates, lower fees and attractive terms to drive the consumer toward a lending institution's first-lien mortgage product offering will only go as far as the closing table. After the loan has closed and the homeowner has taken possession of the property, there is no strategy in place that incentivizes the homeowner to continue to make timely and consistent mortgage payments. Some lenders have mistaken late fees and collection calls as "incentives to pay," but those strategies are only reactive (as opposed to proactive) and are as far from an incentive as the carrot is from the stick.

The truth behind why historical delinquency rates prior to 2007 were low is debatable. Most will say that the homeowner makes regular and timely mortgage payments because of some inherent moral obligation. While there is some truth to the homeowners' innate desire to do the right thing, the simple fact remains that the reason homeowners historically paid their mortgage in full and on time is that they had the incentive to pay.

The incentive, however, did not take the form of a rebate, or reward points, or gift cards. For decades, the incentive to pay the mortgage was the equity in the home. To be clear, there are peripheral incentives as well - like shelter - but the overriding reason borrowers had remained current on their payments was to preserve and protect their equity.

Now fast-forward to 2007. Home prices had already begun a steep decline that continues today. Steep price declines of more than 50% in many areas of the country not only wiped out trillions of dollars of home equity, but also largely eliminated homeowners' incentive to pay their mortgage. Homeowners began to walk away from their homes, which many economists believe is a strategic and astute financial decision. That decision to walk is made for one simple reason: the incentive to pay has disappeared to the point of no return.

According to Oliver Wyman/Experian, 35% of all defaults through the middle of 2010 were, in part, strategic. The homeowners who once saw their home as the single greatest asset in their portfolio now view the monthly payments associated with maintaining an underwater asset as burdensome and discretionary. Therefore, it would stand to reason that when payments become discretionary, the idea of incentives becomes relevant.

A solution for all?

So, what needs to be done now to fix this broken system? The answer is both simple and complex: Create an alignment of interests between all stakeholders and design an incentive that benefits all parties.

However, too many people in the industry and in government are looking at loan modifications and refinancing as the tools to loss mitigation. Admittedly, these solutions help those borrowers who truly need relief with monthly cashflows.

But this type of relief only works when the homeowner has a cashflow problem. The alignment of interest, in this case, comes when asset owners (banks, investors) that are the recipient of future cashflows sacrifice a portion of those cashflows in exchange for greater certainty of lower, longer-term cashflows.

Unfortunately, while it's easy to create a path for providing help for homeowners that need payment relief, there is no historical data for creating a similar path to homeowners that need equity relief. Equity relief, simply put, refers to creating a mechanism or program that will prevent strategic default.

From a purely risk-management standpoint, there is no difference whatsoever between a loss related to strategic default and a loss associated with a traditional affordability default. No overriding conclusions have been drawn on loss mitigation methodologies or practices that could either prevent default or reverse the trend. Banks would simply let the loans default, write the loan down and absorb the loss.

This was not too big of a deal when those losses were a mere fraction of the financial institution's overall new worth. Today, however, with more than 12 million homes in a position of negative equity and trillions of dollars in lost value since the end of 2007, things are much more dire.

As a result, we are seeing incentives gone awry. The lender has forgotten (or, more likely, never realized) that homeowners see their home as something more than merely shelter. The home also represents an investment by the consumer. When that investment has lost a substantial amount of its value, the homeowner will begin to view that home through a different set of eyes: Shelter can be easily recreated by moving or quickly renting, and the desire to continue to pay the mortgage drops.

Also, when the punishment associated with delinquency becomes less severe or when delinquency even becomes acceptable, then the default decision simply becomes easier. Really, when was the last time you heard of a homeowner getting arrested for a strategic default? SM

Frank T. Pallotta is executive vice president and managing partner at Loan Value Group LLC, based in Rumson, N.J. He can be reached at frank@loanvaluegroup.com.