

Achieving Best Practise – Mortgage Underwriting

By Richard Pinch

Problem

In recent months there have been tentative signs in the mortgage market that lenders are starting to expand their lending again since the onset of the recession. LTV restrictions are being relaxed and margins are starting to fall for tracker type products. This is likely to be driven by house prices appearing to stabilise and flows to arrears reducing for the first time since the recession. For those lenders who have the risk appetite and the capital they may be looking to continue this expansion and further increase lending into 2010. But have these lenders considered the lessons from the recession when defining their underwriting criteria for this new lending? Potential problem areas could be:

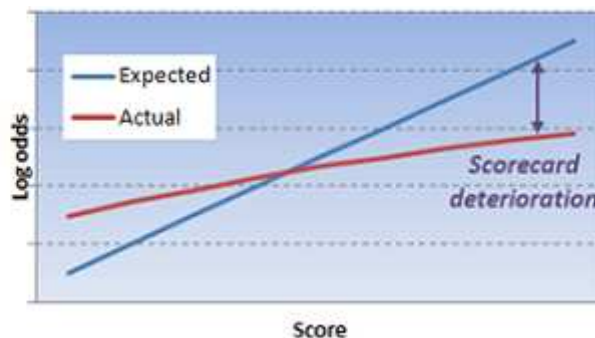
- Customer risk: unemployment is expected to continue to rise through to 2010, how can a lender mitigate the impact of this on new originations?
- Customer affordability: customers may appear to have head room in their monthly disposable income, but what will happen if rates rise?
- Asset Valuation: House price volatility has increased and with HPI flattening, are lenders confident in the valuation that they have sufficient equity if problems occur?
- Third Parties: how do lenders decide which brokers, intermediaries and solicitors to do business with?
- The FSA Mortgage Market Review: if proposals are implemented this will mean big changes to the way affordability is assessed. Can lenders be doing anything now to limit the effect of any new regulation?

Approaches

For lenders who want to get back quickly into the market then a simple approach could be to use the existing underwriting strategy and hope that it is appropriate for the new sales. This would be in conjunction with some basic policy changes such as altering maximum loan values, LTVs and debt to income or affordability ratios. There are some further activities which should be carried out to ensure some learning from recent performance is included:

- Scorecard cut-offs: check for any misalignment in the existing scorecard and review the cut-off. The example below illustrates what some lenders may find – deterioration in scorecard performance

**Example:
Scorecard
deterioration
can undermine
any benefit
from scoring
models**



- Fraud detection rules: review performance of existing rules and bring in any learning from internal fraud investigations
- Affordability: if regulations are changed, change policy appropriately
- Third parties: ensure list of approved third parties does not include any banned or suspicious firms
- Underwriters' mandate and discretion: if policy has been amended, underwriters' mandate and discretion will need to change to reflect the difference in the risk profile of the population

This basic type of approach could work in the short term and give lenders the opportunity to grow their book, but some caution should be exercised if the lender is targeting higher risk lending at the upper end of LTV or loan amount ranges. For this type of lending the lender should consider a more detailed review of its strategy.

Best of Breed

Next we consider what lenders should be doing who wish to expand lending with the most robust and appropriate lending strategy. These activities are by no means exhaustive and prioritisation should be driven by the risk profile of who they are targeting. In fact, understanding who this lending is targeted at should be one of the first activities as this should influence the analytics required to build and design the strategy. For example, if first time borrowers are targeted but little of this business has been written in the past, then this can be a problem as the scorecard may not be appropriate for this type of customers. Other activities can include:



Third Parties

Some lenders may consider that targeting customers through a direct proposition only will take away the risk of fraud on the behalf of brokers, and if the direct channel is large and well known enough this is a sensible approach. However for many lenders a broker offering is essential, so what can those lenders do to ensure both fraud and risk is managed effectively. Bringing together both internal and external fraud investigation information is the first step. Follow this by data analysis and investigating fraud and arrears rates by third parties to identify those who have a higher incidence of bad behaviour (which is unexplainable) vs the total population. Bringing all this information together should give you a list of people you wish to do business with. This list should be regularly reviewed and monitored with the latest internal and external information.

Underwriting

Lenders may need new scorecards if analytics have shown that the existing models are not appropriate. Before rebuilding these scorecards, lenders could take the opportunity to explore if using a multi-bureau approach will give more discrimination as has been the case in with some lenders we have worked with. When building the scorecard it is crucial that it will work on the expected originations population and not what has been originated historically.

Analytics should be carried out on existing fraud detection rules to verify if they are still working and if any new rules should be introduced. Again, as with third parties, this should include both internal and external information.

With the possible introduction of new guidelines on how lenders should assess affordability, this could be a good opportunity for firms to review how any affordability policy has worked in the past. Possible questions lenders might ask are:

- Should affordability policy be the same for all customer type? (e.g. first time buyer vs remortgage)
- Should affordability policy be the same for all income types? (i.e. should maximum thresholds be introduced for different incomes regardless of affordability?)
- Can some of the components of customers income and expenditure be verified with bureau data?
- What stress should I use on affordability to ensure a customer can afford the payment if rates rise? This should be linked to a lenders view of future rates.

More stringent affordability checks should also help identify fraudulent applications where the income may be misstated.

For manual underwriters, it is also a good opportunity to review mandates and discretion limits. There is evidence from lenders that some of the bad lending that was underwritten prior to the



recession was on loans that were outside policy, but the underwriter had the discretion to go outside this policy and approve the loan. Analytics could provide evidence of this if this data is available and should be used to define the appropriate changes to underwrite discretion limits.

Asset Value

Although house prices have stabilised, some commentators are predicting further falls if more properties come on to the market pushing down prices. Lenders should understand if they have any concentration risk to particular regions or property types, which may be more susceptible to any future price falls. This could inform the underwriting strategy by targeting specific regions or property types.

When valuing the property, understanding the confidence levels around a valuation are important and new desktop asset assessment tools coming onto the market can give lenders additional insight on top of the valuation. If data shows that for a particular property, the region it is in has shown high volatility in house prices the lender could consider asking for a higher deposit to give greater insurance against falls.

Conclusions

We are not proposing that lenders carry out all the tasks discussed before increasing lending but they should consider what risks they are most exposed to and prioritise the risk management activities accordingly. For more information about Euristix work in mortgage underwriting please contact Richard Pinch: richard.pinch@euristix.com.