



Thriving in a Challenging Mortgage Market

The level of analytical sophistication used within mortgage portfolio management has often lagged behind that applied in other areas of the credit industry. The benevolent economic conditions experienced until recently led to low default rates, while soaring house prices helped ensure low levels of loss when defaults did occur. In this environment, efforts were focussed on pricing initiatives and product design to drive growth; there was little impetus to invest in analytical processes to support the other aspects of mortgage portfolio management.

In the last twelve months this picture has changed dramatically. Effects of the faltering economy are being felt acutely in the mortgage sector, with funding disappearing, repossessions on the rise, and the fall in house prices leaving lenders facing the possibility of substantial real losses. Property prices have fallen 11% in the last year, while food, petrol and utilities costs are running at a record high. With the RMBS investment market effectively closed and the blanket adoption of conservative lending strategies, the number of mortgage approvals is down 71% on last year. Many borrowers, unable to re-mortgage, are moving onto variable rates that they are struggling to afford; repossessions have already shown an increase of 48% in the first half of 2008.

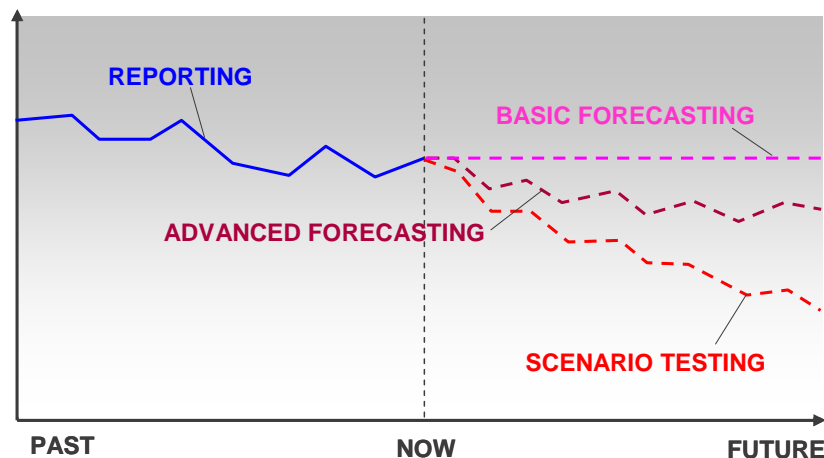
In this new environment organisations are striving to understand the full intricacies of their own portfolios, but most are lacking the tools and processes to help them successfully achieve this. In many cases, even understanding the behaviour already manifesting within the portfolio is not easy. The economic landscape has changed dramatically in a short time and performance shifts are to be expected. It is vital to have in place the reporting infrastructure and alert mechanisms to highlight these changes quickly and to understand both their severity and significance. In a traditionally stable sector such as mortgages, many lenders are finding their reporting tools to be insufficiently responsive and detailed to track their now mercurial portfolio behaviour.

While statistical tolerances and market view alert triggers can highlight any deviances within the portfolio, this does not immediately reveal the significance of these changes to the future performance and value of the business. Uncovering such insight requires the application of forecasting tools to predict the behaviour of the portfolio under these new conditions. How will a recent increase in arrears go on to affect default rates? Will a reduction in prepayments counteract any additional losses and preserve profit levels? Or will adverse selection occur, with only the best customers leaving and the portfolio quality deteriorating? Fundamentally, how are these changes in behaviour affecting value at the customer level? Answering these questions requires powerful, up-to-date and flexible forecasting models which many lenders do not have access to and do not have resource available to develop.

To complete the construction of an optimal portfolio insight and management process, one additional capability is required: that of scenario testing. In the halcyon days of strong economic growth, scenario and stress testing were viewed primarily as a regulatory chore providing little in the way of real business benefit.

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In today's changing economic and market climate however, the ability to stress the segment & portfolio level forecasts provides a powerful additional tool for portfolio management. The real benefit comes not from identifying likely portfolio performance under key scenarios, but from using this information pro-actively to drive management decisions. This means ensuring that risk policy is aligned to a forward rather than backward-looking view. Examples of how to achieve this include defining underwriting strategies based on a range of downturn scenarios, or informing segment sale decisions based on both forecast and stressed performance measures.



Investing in this level of sophistication to derive greater insight into the portfolio can seem a daunting task, especially given the gap present between this ideal and current processes. However the benefits of this approach are immense. The portfolio manager who views and manages their portfolio in this way can react more quickly and more appropriately to change. Attaching dynamic forecasting and stress testing to a detailed understanding of current performance reveals the true nature of the portfolio and significantly reduces the chance of encountering any nasty surprises. Proactively using this information to help design new business strategies and drive pre-emptive actions completes the feedback loop and confers maximum value.

The mortgage industry is in the middle of a difficult period, with the economic changes hitting hard. In these unfamiliar conditions it can be difficult to determine the best actions to take. Blindly pursuing out-of-date or uninformed strategies will lead to disaster, but in the long term so may the super-conservative lending adopted by so many. Survival and success will depend on clear insight and gleaning the most accurate view of what lies ahead. Those who invest in the tools that provide these things will find them invaluable, and may well find this time of difficulty and crisis becoming one of opportunity and profit.