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# Budget Finance Company: A Loan Modification Case Study

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At the heart of the world's toughest problems are human behaviors. Our expertise in behavioral science allows us to see these problems differently. We notice the overlooked details that make the bigger picture. We invent fresh solutions because we know the power details have to nudge us in different directions. We're out to improve tens of millions of lives decision by decision.

# Contents

<b>Executive Summary</b>	2
<b>I. Introduction</b>	4
<b>II. Why Are Modifications Not Happening?</b>	5
Mapping Out the Standard Modification Process	5
The Behavioral Perspective: Identifying Process Bottlenecks	6
<b>III. How Can We Improve the Modification Process Using Behavioral Science?</b>	8
Action #1: Build Trust	8
Action #2: Guide Borrower to Action	9
Action #3: Show A Clear Path to Completion	11
How Is This Different From the Standard Process?	12
<b>IV. Has This Been Tried Before? The Case of Budget Finance Company</b>	13
BFC's Modification Process	13
BFC's Performance	15
<b>V. Is this a Scalable Solution?</b>	17
Replicability	17
Scalability	17
Economic Feasibility	18
<b>VI. What's Next?</b>	19
<b>References</b>	20
<b>Appendix</b>	21
Details of the Standard Modification Process	21

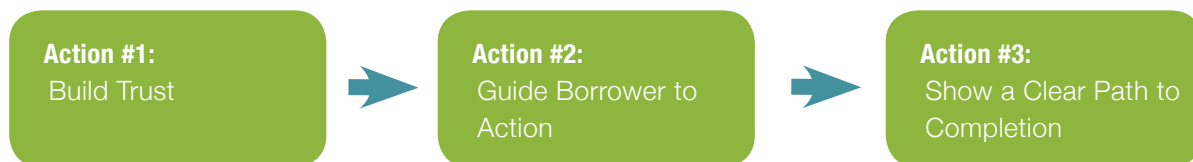
# Executive Summary

In 2007, the US housing market entered its worst foreclosure crisis since the Great Depression, resulting in a significant rise in default and delinquency rates among mortgage borrowers. While the US government responded by instituting the Home Affordable Modification Program (HAMP), the initiative has been able to reach less than 35 percent of the three to four million distressed homeowners it was intended to support<sup>1</sup> (Hope Now, 2011).

The fields of psychology and behavioral economics provide a fresh point of view as to why modification efforts have not achieved the expected results. Research in behavioral economics suggests that seemingly minor design features that fail to take into account borrower psychologies can contribute to the low rates of borrowers completing the modification process (ideas42, 2010).

Low modification completion rates, which diminish the effectiveness of a well-intentioned and much needed program, are a major issue across mortgage servicers. In order to understand why borrowers fail to complete the loan modification process, ideas42 conducted a qualitative study of distressed homeowners in the Detroit area and examined mortgage servicers' operations to identify behavioral bottlenecks that impede completion. From a behavioral perspective, we found three seemingly simple, but powerful psychological issues affecting borrowers during this process: (i) lack of trust; (ii) avoidance and procrastination; and (iii) confusion and frustration.

Based on our findings, we designed a three-pronged behaviorally-informed loan modification process that addresses each of these barriers:



**Action #1: Build Trust.** Borrowers' willingness to cooperate with the modification process decreases substantially when they do not trust the servicer or do not believe that the agent has their best interest at heart. Naturally, if a borrower talks to the same agent and builds a relationship with her, that establishes a strong foundation of trust. However, any number of small elements of the process can trigger mistrust. For example, the agent must verify the borrower's name and address at the beginning of every call. Without any explanation that this is a compliance and security requirement, borrowers could start suspecting the agent doesn't have all their information recorded properly. Thus, establishing a trusting relationship with the loss mitigation agent is a

<sup>1</sup> Hope Now estimates that as of September, 2011, approximately 857,000 borrowers have been approved for permanent HAMP modifications compared to the envisioned three to four million.

necessary foundation for engaging borrowers with the modification application process.

**Action #2: Guide Borrower to Action.** The standard process asks borrowers to complete a lengthy, complicated set of financial documents.<sup>2</sup> Many borrowers just don't send anything back, while others send back incomplete documents. Some borrowers may simply lack the know-how to complete the financial forms on their own. Others most likely procrastinate to the point of imminent foreclosure, and then give up. Procrastination is common when the task is daunting or tedious—and filling out a loan modification package is both. However, if the task is broken down into manageable steps, and specific dates and times are set up for the borrower to complete each step, behavioral research suggests that borrowers are much more likely to complete their loan modification application. Moreover, with the support of a trusted loss mitigation agent, they will do it faster.

**Action #3: Show a Clear Path to Completion.** Many borrowers report experiencing confusion and frustration with the modification process, which often leads to early dropouts (ideas42, 2010). One reason is that the forms are complex, and instructions and requirements are not clearly outlined. For example, when borrowers who have already submitted a loan modification application receive a foreclosure notice, the servicer does not explain that the communication is simply a legal requirement. Consequently many borrowers interpret it as a modification rejection. Not knowing what to expect is also a major source of frustration. Most notably, borrowers rarely know how long it is likely to take for the servicer to get back to them on an inquiry or what documents are expected of them. Setting expectations of what comes next in the modifications process, and what is expected of the borrower at each step, helps reduce confusion and frustration.

ideas42 has used these insights to design an improved loan modification process. The result is a

comprehensive, behaviorally-informed solution for mortgage servicers to guide borrowers to better outcomes. More tangibly, our behaviorally-informed modification process includes a complete set of specific procedural add-ons, agent scripts and training materials, which present a meaningful yet manageable departure from the standard modification process. This report presents the procedural changes embedded in the behaviorally-informed process.

In the course of our research, we came across a small mortgage servicer, Budget Finance Company (BFC), that is using a loan modification approach with many similarities to our behaviorally-informed process. Compared to industry averages, BFC reaches more delinquent borrowers and experiences dramatically lower redefault rates following modification despite being a subprime lender. While some may point to BFC's small size and unique portfolio of subprime loans, we have found that BFC's behavioral approach to loan modification has played a significant role in these outcomes.

BFC is a small servicer with a unique subprime portfolio. It is reasonable to ask whether a behaviorally sound approach can only work for small, nimble servicers. While some elements of the process, such as a single point of contact from early stages of delinquency, are indeed difficult to scale, most of the behaviorally-informed design is very scalable. Naturally, specific details need to be customized to a given servicer's systems, processes, and staffing structure.

ideas42 is open to partnering with a mortgage servicer company to test the concepts in our behaviorally-informed modification process in a pilot. We anticipate that our findings are applicable across the mortgage industry and beyond, and can ultimately lead to quicker, easier resolutions and increased financial stability for distressed borrowers. □

2 Based on interviews and proprietary data from two large mortgage servicers.

# I. Introduction

**B**eginning in 2007, the US housing market experienced the worst foreclosure crisis since the Great Depression. Delinquency and default rates have increased almost twenty-fold compared to pre-crisis averages, with almost one in eight mortgage borrowers delinquent or in foreclosure proceedings.<sup>3</sup> In response, the US government instituted the Home Affordable Modification Program (HAMP) to help struggling homeowners at risk of foreclosure by lowering monthly payments for those who qualify for a mortgage modification program.

Despite the magnitude of the mortgage crisis and the considerable financial benefits of obtaining a modification, the initiative has reached less than 35 percent of the three to four million distressed homeowners it was intended to help<sup>4</sup> (Hope Now, 2011).

What could explain the low take-up rate of loan modifications? Popular accounts have attributed the low modification rates to strategic defaults by borrowers, as well as calculated modification denials on the part of servicers. On the contrary, we at ideas42 believe that other, less obvious factors are at play. We use the lens of behavioral economics and psychology to examine why modification efforts have not reached the expected outcomes. We find that seemingly minor design features can contribute significantly to modification dropouts.

To better understand the behavioral bottlenecks inherent to the standard modification process, ideas42 has interviewed both distressed homeowners and mortgage servicers. Based on the findings from this case study, as well as our understanding of behavioral economics, we have designed a behaviorally-informed modification process, which overcomes the behavioral bottlenecks in the standard modification process and guides distressed borrowers to modification completion.

This report is organized as follows: Section II describes the psychological barriers identified at different stages of the modification process (the standard modification process is described in the Appendix). Section III describes the behaviorally-informed process that ideas42 has designed to counteract the psychological barriers that lead to borrower dropout in the current process. Section IV outlines the modification process of a boutique mortgage servicer company, which has incorporated behavioral elements in its modification process, and compares its loan performance metrics to industry averages. Sections V and VI discuss the scalability of the proposed behaviorally-informed solution, and lay out next steps for testing the concepts and process changes in a pilot study.

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<sup>3</sup> The Mortgage Bankers Association report for Q3 2011 reports the combined percentage of loans at least one payment past due or in foreclosure to be 12.63% on a non-seasonally adjusted basis.

<sup>4</sup> Hope Now estimates that as of September 2011, approximately 857,000 borrowers had been approved for permanent HAMP modifications compared to the envisioned three to four million.

## II. Why Are Modifications Not Happening?

The financial incentive for obtaining a loan modification averages a monthly payment reduction of \$562 for HAMP (OCC & OTS Report, 2011). This amounts to savings of close to \$135,000 over 20 years, which is substantial financial relief for most families. It is surprising, then, that many distressed homeowners do not take advantage of this financial opportunity.

A recent program by Bank of America has confirmed these findings. Since May 2012, they have offered 60,000 distressed borrowers an opportunity to slice an average of \$150,000 from their total mortgage payments, and to date, less than 50 percent have even responded to the offer (Bloomberg News, 2012).

In a standard cost-benefit analysis, borrowers would only turn down a modification that saved them a substantial sum of money if the expected costs of obtaining such a modification outweigh the expected benefits. Yet the current modification application process is free<sup>5</sup>, apart from the time and energy needed for filling out the forms and compiling the necessary documentation. Even if the forms do cause confusion and take a few hours to fill out, and the likelihood of getting approved for a modification is under 50 percent (ideas42, 2012), the anticipated financial benefit should be enough to urge eligible borrowers to complete the process.

### Mapping Out the Standard Modification Process

In order to better understand distressed borrowers' situation, ideas42 conducted qualitative interviews with distressed homeowners in the Detroit area. We also surveyed several large mortgage servicers on their experiences of implementing the process, listened to collections and loss mitigation calls, and talked to counseling agencies. Our goal was to understand the typical loan modification process and identify the perceived bottlenecks that impede completion (see Appendix for further details regarding the standard modification process).

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<sup>5</sup> Apart from the recording fee due as the permanent modification is finalized, which on average is a couple of hundred dollars, but depending on the state, could be as high as \$2,500.

Figure 1: Key Elements of the Standard Modification Process from the Borrower's Perspective

Standard Loan Modification Process
Speak to many different people and repeat your story
Complete complex documentation with little help
Sometimes need to re-send documents
Receive confusing communication, such as the foreclosure notice
Participate in lengthy process that can take several months

## The Behavioral Perspective: Identifying Process Bottlenecks

In the case of mortgage modifications, popular accounts of strategic defaults on the part of borrowers and deliberate modification rejections on the part of servicers have not been able to explain why the majority of distressed borrowers do not complete the modification process. One explanation could be that borrowers are much more likely to give up pursuing a modification if the process feels intimidating.

The fields of psychology and behavioral economics provide a fresh point of view as to why modification programs have not reached the expected results. This section describes the psychological barriers that cause borrowers to drop-off at various stages of the modification process and drastically diminish the effectiveness of a well-intentioned and much needed program.

### Psychological Barrier #1: Lack of Trust

Trust is hard to build, but it constitutes one of the key prerequisites for cooperation. Research in procedural justice has shown that people cooperate only when they perceive processes and procedures to be transparent and fair (Thibault and Walker, 1975; Lind and Tyler, 1988). Thus, it is not surprising that lack of trust may cause borrowers to drop out midway

through the modification process. Specifically, many borrowers do not trust the modification process at the outset, while others lose trust during the application process itself.

Borrowers may lose trust with a modification process for a number of reasons. For example, borrowers often lose trust as a result of servicer errors such as lost or misplaced documents. Furthermore, speaking with a different agent on every call can create the feeling that the borrower is not being heard. Less obvious steps can also contribute to a sense that the process is not going anywhere, like asking the borrower to verify her identity and financial information on every call. Additionally, the complexity of the forms often demotivates borrowers and causes them to feel that they are dealing with an opaque, unreliable and “faceless” bureaucratic machine. Inconsistent information from different agents can exacerbate the issue. Not understanding how the system works may also create the wrong impression, mistakenly equating procedures to protect borrower privacy to lack of understanding and incompetence.

The nature of the servicer-borrower relationship carries a power dynamic, in which the borrower often considers the mortgage servicer as an opponent rather than an ally. In such an adversarial setup, establishing a trusting relationship early on is crucial

*“Despite a sincere intent to do so, people fail to act in their own best interest...this so-called intention-action gap can be witnessed by the low participation rates in 401(k) retirement plans.”*



for the successful outcome of the process, and therefore is one of the key goals for a behaviorally-informed loss mitigation process.

## **Psychological Barrier #2: Avoidance and Procrastination**

The psychology literature documents many real-world situations where, despite a sincere intent to do so, people fail to act in their own best interest. This so-called intention-action gap can be witnessed in areas as diverse as drug adherence, exercise and personal finance. The low participation rates in 401(k) retirement plans, specifically when such plans are dependent on the employee opting-in, are one such example. A study with a large employer showed that switching from an opt-in plan to automatic enrollment dramatically enhances the retirement savings behavior of employees, increasing both participation and saving rates (Madrian and Shea, 2001).

Further complications can arise from both avoidance and procrastination. In the case of loan modifications, borrowers tend to procrastinate on filling out their financial forms. One reason involves the complexity of the forms, which often overwhelms distressed borrowers. For example, the Request for Modification and Affidavit (RMA) form warns borrowers that providing false or inaccurate information is tantamount to perjury, and carries a penalty. Without clear guidelines for filling out the paperwork, the fear of making a mistake may discourage delinquent borrowers from ever completing the forms. Inconsistent information about what is expected of the borrower and the threat of perjury for incorrect information also act as an additional deterrent to completing the application forms.

Apart from the complexity of the forms, obtaining various proofs of income and notarizing the documents add additional tedious steps to the process. In general, the presence of multiple small, but unpleasant steps acts as a deterrent against completing the process. Many servicers shared anecdotes of borrowers dropping out in the last stages of the application process because of failing

to complete a seemingly simple task. One servicer reported that up to 40 percent of borrowers who fill out the application documents and get an approval, end up dropping out due to a failure to notarize their execution documents (ideas42, 2010).

Often the fear of making a mistake manifests itself in continual procrastination with the familiar excuse, *"I'll do this tomorrow."* Combine these excuses with the financial distress that borrowers are experiencing, and it becomes obvious why many borrowers end up ignoring the onerous modification process. For many, this leads to a vicious cycle where avoidance feeds into the procrastination phenomenon, resulting in borrowers losing their chance for a modification.

## **Psychological Barrier #3: Confusion and Frustration**

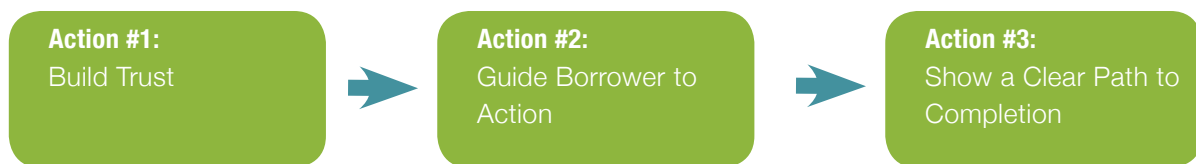
It is hard for people to do something when they are not clear about what is expected of them. The standard modification process, with its opaque requirements and instructions, contributes to borrowers experiencing confusion and frustration with the application. That often leads to early dropouts (ideas42, 2010). One reason is that forms are complex, and instructions and requirements are not clearly outlined. For example, when borrowers who have already submitted a loan modification application receive a foreclosure notice, the servicer does not explain that the communication is simply a legal requirement. As a result, many borrowers interpret it as a modification rejection. Not knowing what to expect is also a major source of frustration. Most notably, borrowers rarely know how long it is likely to take for the servicer to get back to them on an inquiry or what documents are expected of them.

# III. How Can We Improve the Modification Process Using Behavioral Science?

**O**ur team has developed a behaviorally-informed modification process that addresses the key psychological bottlenecks to modification completion. The approach consists of three focus areas and prescribes small changes within each area (see Figure 2 below).

The foreclosure crisis is a complex problem, and a single change in the modification process is unlikely to result in a significant difference in outcomes. If not addressed, even a seemingly trivial instance of doubting the process or a source for confusion can lead to borrower dropout. ideas42's behavioral audit has identified the elements of the modification application process that are crucial for the success of the overall program. Our comprehensive solution includes a series of small, simple changes to the way the servicer interacts with the borrower. The behaviorally-informed process aims to address multiple psychological bottlenecks at every stage of the modification process in order to improve the customer experience and increase the number of completed modifications.

Figure 2: Three Focus Areas of the Behaviorally-Informed Modification Process



## Action #1: Build Trust

Building trust in the loss mitigation process and improving the borrower-servicer relationship is crucial to ensure that the borrower cooperates and completes the modification application. As we have already discussed, borrowers' willingness to cooperate decreases substantially when trust is lost or when borrowers do not believe that the agent has their best interest at heart. Naturally, a personal relationship helps to build trust, and psychology research suggests that people are more persuaded by and trusting of people that they like (Cialdini,

2001).

Establishing a personalized relationship with the borrower is essential for the success of the modification process. If the borrower talks to a different agent every time she interacts with the servicer, a trusting relationship will not be established. That is why the behaviorally-informed modification process assigns borrowers to a **single point of contact** as early as possible in the process. In reality, most servicers have different staff for the collections and loss mitigation stages. To allow for a continuity of service, we recommend account ownership in collections, which can be handed off to a single point of contact during the loss mitigation stage.

Still, account ownership without a good rapport between the borrower and the servicing agent could be counterproductive. For that reason, in an attempt to increase the likelihood of good rapport, it is crucial to introduce a process by which single-point-of-contact agents are assigned to borrowers. It is particularly important for the collections agent who does the initial contact to assess if a good rapport exists and if not, to proactively assign the borrower to a new agent.

Agent scripting plays an important role in how the servicer can **establish trust** with the borrower. Currently, it is not uncommon for loss mitigation agents to ask the question, “Why have you fallen behind?” If voiced with the slightest hint of judgment during the initial contact, such a question can provoke defensiveness and trigger avoidance in the borrower. Furthermore, this question does not directly ask for financial information that the servicer needs in order to assess the level of financial distress. The conversation could be better framed in terms of understanding the details around a potential income loss or a spike in expenses.

The initial conversations with the borrower provide an excellent opportunity to build rapport. The introduction could **stress the importance of personalized service**: “I’m here to help you with

your mortgage. My team and I will take care of you.” Another way to establish trust early on is to give a small concession on one of the first calls, such as waiving a fee or calling back with an update. Small gestures can help to **set a pattern of reciprocity** in the agent-borrower relationship, in which the borrower feels compelled to complete the forms or follow-up on financial inquiries.

Finally, **setting clear expectations about next steps** helps establish trust in the modification process as a whole. Agent scripts could incorporate information about next steps so the borrower is informed and prepared about what to expect: “*I want to review all the options available to you based on the information you gave me. I will get back to you within 2 weeks.*”

## Action #2: Guide Borrower to Action

The behaviorally-informed modification process is designed to proactively engage with the borrower and counteract the tendencies for avoidance, inertia, and procrastination. The goal is to make it easier for the borrower to successfully complete each step of the process and to offer support if the borrower encounters a specific difficulty along the way. The modification process contains many unfamiliar steps – financial forms, proof of income documentation, notarized signatures. Delinquent borrowers often procrastinate on filling out the paperwork for a modification because they do not understand what is expected of them. Confusion, compounded with an avoidance mentality in which the borrower avoids acknowledging their financial distress, often leads to repeated procrastination until it is already too late.

The current process puts responsibility on the borrower to initiate contact if they need assistance with any part of the application, which may further exacerbate the issue. Even more, borrowers are incentivized to stay on track with their applications by deadlines and threats of losing their home. Such strategies are counterproductive in establishing a trusting relationship and psychologically trigger both

Figure 3: Three Focus Areas and Associated Steps of the Behaviorally-Informed Modification Process

1. Build Trust	2. Guide Borrower to Action	3. Show a Clear Path to Completion
Assign single point of contact for borrowers	Shorten and simplify the process by decreasing the number of steps	Set clear expectations about process timelines
Build rapport by stressing personalized service	Break down paperwork into discrete steps	Openly disclose information and clearly communicate potential outcomes
Develop agent scripts that establish trust	Develop agent scripts that encourage and guide the borrower	Acknowledge borrower achievements
Make concession early on to set a pattern of reciprocity	Engage in proactive troubleshooting	Engage borrower in plan-making by setting deadlines
Set clear expectations about next steps	Facilitate plan-making and set soft deadlines	

avoidance and a tendency to hold onto the house even if it is not a viable solution financially.

In contrast, the behaviorally-informed modification process mandates agents to take responsibility for monitoring the progress of modification applications. The proposed adjustments, such as **facilitated plan-making, soft deadlines and proactive troubleshooting**, aim to help borrowers overcome the fear of making a mistake and complete the process steps in a timely manner. A field test conducted during the 2008 presidential elections showed that prompting people to make a plan for when and how they would vote increased voter turnout (Nickerson and Rogers, 2010).

Similarly, **agent scripts** can encourage and guide borrowers to complete the various stages of the modification application. For example, before sending a financial package to the borrower, the agent would say: “You’ll get the financial package by Tuesday. I’ll call you on Wednesday to walk you through the different sections. Does 4 PM on Wednesday work for you?”

Another way in which servicers can reduce borrower procrastination is by **decreasing the number of**

**tasks and process steps** that demand borrower attention. It has been proven that prospective memory, or the ability to remember to complete tasks in the future, is negatively affected by the burden of multiple tasks (Marsh, Hicks and Landau, 1998). Reducing the number of stressors that borrowers encounter in the period they are applying for a modification can make it easier for them to stay on track with the application process. For example, agents can offer a post-dated payment for the month in which the financial package is due. This way, they help relieve borrowers’ stress level, so borrowers can focus on what is important in the long-term – obtaining a modification.

### Action #3: Show a Clear Path to Completion

Currently borrowers report high levels of confusion and frustration with the modification process, which often lead to early dropouts. The behaviorally-informed process aims to decrease such frustrations by **setting clear expectations** about what every step of the process entails. This means that the agent will explain to the borrower what to expect at every stage of the process, be it the time it takes to fill out a form, paperwork requirements, the expected

reduction in interest payments, or the time it takes to review and approve a modification. For example, before mailing a package to the borrower, the agent would clarify: “*The financial forms are being mailed to you today. You will receive the forms by Tuesday, and it will take you about 2 to 3 hours to fill them out.*”

To further reduce confusion, the proposed process **promotes open disclosure of information**. The initial contact agent will explain to the delinquent borrower the importance of providing accurate financial information for making a realistic assessment of borrower options. Based on this assessment, the agent will give an estimate for the expected reduction in interest payments upfront so the borrower is aware of the financial terms of a potential modification. **Communicating the potential outcomes** of a modification clearly will allow borrowers to form realistic expectations and gravitate early on towards the most appropriate solution for their financial situation.

Providing proactive assistance in completing the application is key in ensuring the borrower stays on track. In addition to setting clear expectations, the agent will **engage the borrower in plan-making** by helping her to set deadlines for completing specific tasks. If the borrower is falling behind on a deadline, the agent would proactively reach out to provide assistance. Further, the **required paperwork can be**

**broken down into small, simple tasks**, reducing the occurrence of borrower confusion.

Finally, **acknowledging borrower achievements**, be it obtaining employment pay stubs, filling out a form, or finding a new job, is a powerful tool for keeping borrowers engaged in the process. Affirmation helps to reduce defensiveness by boosting borrowers’ sense of self-integrity (Sherman and Cohen, 2002), and increases the capacity to accept adverse information such as worsening financial distress. Acknowledging successes, big and small, also helps borrowers overcome temporary frustrations and focus on the big picture.

## How Is This Different From the Standard Process?

Each of the three focus areas of the behaviorally-informed modification process includes small steps to address behavioral bottlenecks and encourage completion of the modification process (see Figure 3). While each step may seem insignificant on a standalone basis, together they offer a comprehensive solution for guiding borrowers to better loan modification outcomes (see Figure 4).

Figure 4: Comparison of Behaviorally-Informed Modification Process to the Standard Process

Standard Modification Process	Behaviorally-Informed Modification Process
Speak to many servicing agents and repeat your story	Assigned to single point of contact who knows your case
Complete multiple complex financial forms with little support in filling them out	Complete simpler paperwork with fewer opportunities for mistakes
Sometimes need to re-send documents	Receive assistance and hand-holding to complete the financial forms
Receive confusing communication, such as the foreclosure notice	Feel that each step moves along quickly
Participate in a process that can take several months with no clear path to completion	Participate in process that is completed in days

## IV. Has This Been Tried Before? The Case of Budget Finance Company

The “standard” loan modification process described above may be typical for the industry, but not all mortgage servicers use the same procedures. Budget Finance Company (BFC) is a small mortgage servicer that is using a comprehensive approach to its loan modification program with many similarities to our behaviorally-informed process.

BFC is a family-owned subprime mortgage originator that holds all its loans on the balance sheet. The company is funded by about 300 individual investors and debt from Wells Fargo. Loans are originated via a phone-based retail channel, and the majority of loans are subprime, light documentation, cash-out refinances to low credit score borrowers. The average borrower FICO score at origination is below 600. Most mortgage loans are single-family properties located in California, with some loans in Arizona, New Mexico, Oregon, and Washington State.<sup>6</sup>

### BFC’s Modification Process

BFC offers a personalized, case-by-case approach to mortgage servicing. The company’s intuitive adherence to behavioral principles informs all aspects of the modification process, from outreach and borrower communication to financial package completion and modification approval.

#### Outreach

BFC uses a **highly personalized approach** in determining when to initiate first contact with delinquent borrowers. The collections team monitors past customer payment patterns to determine if a payment delay is out of the ordinary. For example, borrowers who habitually have paid on time, but start being delinquent, are contacted before the standard 30 days past due date. This allows the company to detect distress early. BFC manages to reach close to 100 percent of its delinquent borrowers in comparison to average servicers that

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6 Sheldon Cohn, interview by Piyush Tantia, Los Angeles, CA, October 2010.

Figure 5: Aspects of BFC's Modification Process Related to the Three Focus Areas

1. Build Trust	2. Guide Borrower to Action	3. Show a Clear Path to Completion
Apply highly personalized approach	Commit to a formal payment promise	Offer shorter verification package
Capture necessary contact information at origination	Conduct faster application process	Add convenience with extra return channels
Give option to walk borrower through agreement	Work with borrowers to create monthly budget	Set up first payment as post-dated ACH payment
	Suspend rather than cancel foreclosure proceedings to incentivize adherence to modified plan	

are able to reach about 50 percent.<sup>7</sup> Other elements that contribute to BFC's outreach success include ***capturing all necessary customer contact information at the time of origination***. The servicer also uses a series of tactics to reach borrowers who avoid contact, including:

- Avoiding caller ID detection by using various numbers, including cell phones, to call borrowers;
- Sending hand-written notes to add a "personal touch," which makes borrowers more likely to respond;
- Making in-person visits to the borrower's home if other strategies fail.

As a small company, BFC has the flexibility to adapt protocol to the borrower's specific circumstances and needs. This allows agents to build trusting relationships with the borrower and contributes to BFC's outstanding outreach results.

### Application

BFC utilizes the same level of personalized attention to assess the financial circumstances of the borrower and determine workout options. Borrowers who are up to 30 days delinquent, but can guarantee paying their arrears, are offered to make a post-dated payment.

***Committing to a formal payment promise*** makes

it easier for delinquent borrowers to follow through on the payment compared to expecting them to initiate the payment on their own. For borrowers who seem to be withholding information, BFC's agents offer a generous post-dated payment option. As a substitute for a loan modification, this workout allows borrowers to withhold the details of their financial distress, so long as they can meet their future payments.

The agent is authorized to initiate a modification application for borrowers 30 days past due who have proof of permanent financial distress, and for all borrowers who are 60 or more days past due. The process takes one to three days, which is much ***faster*** than the several months under HAMP and other proprietary modifications.

This is partly because BFC offers a ***significantly shorter financial verification package***. For example, BFC does not require copies of the borrower's past tax returns. The process starts with the agent working with the borrower to ***create a monthly budget*** based on the borrower's financial information. Then the agent walks the borrower through the modification offer over the phone and asks the borrower how much he is comfortable paying per month. A BFC proprietary modification, on average, reduces borrower monthly mortgage payments by 27

7 Sheldon Cohn, interview by Piyush Tantia, Los Angeles, CA, October 2010.

percent.<sup>8</sup>

Once a modification agreement is reached, the borrower is sent a seven-page form to fill out. The form can be returned via mail, fax, or e-mail. The **added convenience of the extra return channels** increases the likelihood of the borrower following through. Borrowers are also given the **option to be walked through the agreement** over the phone. The goal of the proactive borrower support is to reduce the opportunities for excuses for not filling out the forms. Once the completed agreement is received by BFC, the borrower is put on the modified payment schedule. The **first payment is set up as a post-dated automated clearing house (ACH) payment**, which aims to habituate the borrower to adhere to the new payment schedule.

## Post-Modification

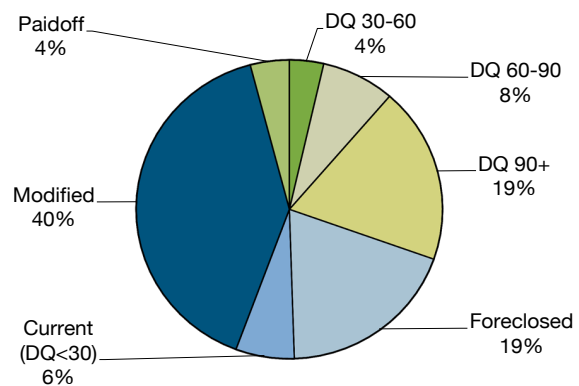
All states in which BFC operates, apart from New Mexico, have a non-judicial foreclosure legislation that allows the foreclosure process to be suspended for up to one year. BFC uses this option to **suspend rather than cancel foreclosure proceedings** during the first year of a newly initiated modification. The looming threat of resuming the foreclosure proceedings acts as a strong incentive for BFC customers to avoid relapsing into delinquency. Borrowers are informed that the foreclosure process has been suspended, but will be resumed if they fall behind on their payments. In most cases, the foreclosure proceedings are already at the sale stage, which means that missing a single payment could result in the property being put up for sale within days. The tangible threat of losing one's home acts as a **strong deterrent against failing to comply** with the modification payment schedule. The effect of that policy can be seen in the stellar redefault performance of BFC loans compared to the industry average. Pending foreclosure proceedings are cancelled after twelve months of on-time payments.

## BFC's Performance

In order to determine whether BFC's behavioral approach to modifications actually makes a difference in outcomes, we used BFC loan data to calculate key loan performance metrics and compared them to industry averages. BFC has a small portfolio of light documentation, subprime loans. The company provided ideas42 with monthly loan data for the period from January 2009 to November 2010. In January 2009, the portfolio comprised 1,897 loans and 20 percent of the portfolio was delinquent 60 days or more. In the period of 23 months, the portfolio grew a mere 3 percent.

Our first set of results examines the 388 loans that were delinquent 60 days or more on January 31, 2009. We estimated the status of these delinquent loans 12 and 22 months later. As depicted in Figure 6, 40 percent of the delinquent loans as of January 2009 had been modified after 12 months. Furthermore, 47 percent of the modified loans had been modified within the first 3 months, which illustrates the expedited modification process at BFC. Also, after 12 months, 50 percent of the portfolio of delinquent loans had a positive resolution—a modification, self-cure, or being paid off—and another 19 percent were resolved in a foreclosure.

Figure 6: Outcomes for BFC's Delinquency Portfolio at 12 Months (January 2009 - January 2010)



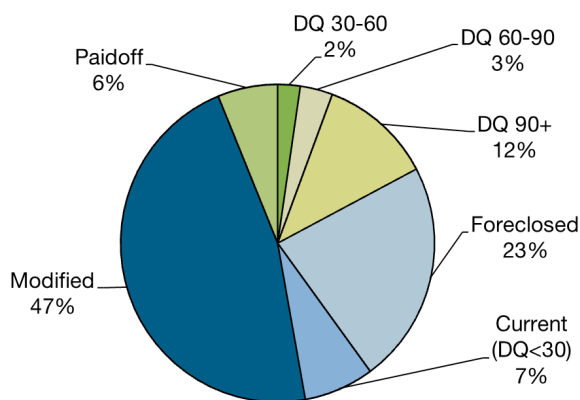
<sup>8</sup> Any rate reductions larger than 2% need to be approved by the head of collections.



The remaining 30 percent of the delinquency portfolio<sup>9</sup> had not resulted in a workout 12 months later, and as of January 2010, were still delinquent.

Figure 7 examines the same delinquency portfolio after 22 months. As of November 2012, the modification rate had increased from 40 percent to 47 percent, and the total percentage of workouts had risen from 70 percent to 83 percent. After 22 months, only 17 percent of the delinquency portfolio was still

Figure 7: Outcomes for BFC's Delinquency Portfolio at 22 Months (January 2009 – November 2010)



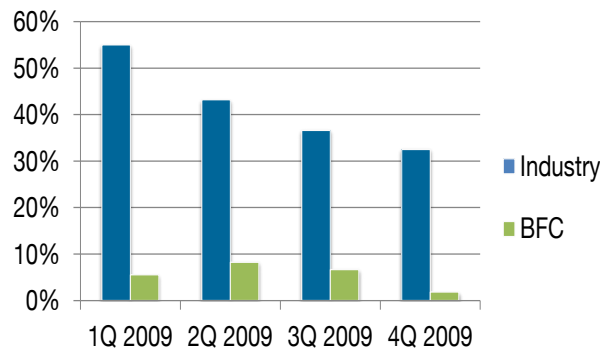
delinquent.

Based on our analysis, ideas42 estimated that within 22 months, BFC was able to establish initial contact with 100 percent of delinquent borrowers, completed workouts with 83 percent, and ultimately modified 47 percent of delinquent loans. By comparison, other mortgage companies typically reach only about 50 percent of delinquent customers (ideas42, 2010). Unfortunately, the industry does not publish workout and modification statistics for delinquent portfolios, which precludes us from making a direct comparison with industry outcomes. Anecdotally, we know from servicer interviews that on average, it takes borrowers two to four months to complete a modification

application with a standard mortgage servicer. On the contrary, BFC aims to complete borrower modification applications within days. We anticipate, but cannot state definitively, that BFC outperforms the industry average in the percentage of their portfolio that obtains modifications, and in the time frame in which these modifications are achieved.

What happens to loans after a modification? Figure 8 compares BFC's redefault rate of loans 12 months after a modification to the industry average.<sup>10</sup> It is clear that BFC's redefault rates are strikingly lower than the industry average. This could potentially be due to BFC's policy of suspending rather than canceling foreclosure proceedings during the first year of a modification. The threat of resuming foreclosure proceedings can act as a strong incentive against falling behind on monthly payments after a modification.

Figure 8: Redefault Rates at 12 Months after a Modification



9 The delinquency portfolio is all loans which were delinquent 60 days or more as of January 2009.

10 In this analysis, the month of modification is counted as the null – zero months after the modification.

## V. Is this a Scalable Solution?

**W**hat lessons can we learn from BFC's modification process that can be applied to the rest of the mortgage industry? After all, BFC is a boutique mortgage servicer with a unique mix of deeply subprime loans and a customer base that does not hold much unsecured debt. If anything, most would expect BFC to perform worse than the industry average. Contrary to all expectations, BFC outperforms industry averages.

### Replicability

Some may postulate that BFC's performance is due to its unique portfolio and small company size, and that no lessons are applicable to the rest of the mortgage servicing industry. However, we believe that the success of BFC is due not to its unique portfolio characteristics, but rather to the company's adept application of behavioral concepts in designing its loan modification process. What BFC is doing right is following modification procedures that serve individual borrower needs, and thus help borrowers to overcome key behavioral bottlenecks associated with completing a modification application. We argue that by adopting a behaviorally-informed modification process, the rest of the mortgage industry can substantially improve its modification outcomes.

### Scalability

Despite the unmistakable success of the BFC modification process, some might argue that this type of personalized, behaviorally-informed solution would be difficult to scale. On the contrary, we believe that the behavioral concepts that underlie BFC's modification process are easily applicable to the servicing operations of mortgage companies. We have identified the elements that can be generalized for the mortgage servicing industry as a whole and have packaged them as a comprehensive, behaviorally-informed loss mitigation process. The proposed approach is based on three pillars:

- Build trust in the system and in the loss mitigation agent
- Guide borrower to action
- Show a clear path to completion

Our behaviorally-informed process includes a complete set of specific procedural add-ons, agent scripts, and training materials. To illustrate the changes in scripting, let us focus on plan-making, a principle used to guide borrowers to faster application completion. The behaviorally-informed script aims to break down the financial package into small, less intimidating sub-tasks, build soft deadlines around them, and provide the necessary

support and assistance in filling out documents:

**During financial info gathering call:** *“I’m going to send you a loan modification application package. It will get you by Thursday. I’ll call you Friday morning to go over it. Does 9 AM work?”*

**Follow-up call 1 (Friday in this scenario):** *“It will take you about three hours to prepare the application package. Can you **work on it Sunday afternoon between 2 and 5 PM?**...I’ll call you Monday at 9 AM to go over any questions you have.”*

**Follow-up call 2 (Monday):** *“Sounds like you made great progress. There are only a couple of things missing. Can you work on getting those **tomorrow afternoon?**...I’ll call you tomorrow evening to check in.”*

**Follow-up call 3:** *“Congratulations! Your package is complete. All you have to do is put it in the envelope. Can you **drop it off at Fed Ex / UPS tomorrow morning on the way to work?** ... Once we get it, I’ll call you to let you know we have it. It will take us two weeks to process it. I know that’s a long time, but please bear with us.”*

These minor agent script modifications are easy to customize and implement in a servicer’s operations, and are conducive to scaling up.

## Economic Feasibility

We envision that our proprietary modification process will not only improve outcomes, but also do so in a cost-effective way. It is important to recognize that the new process will impose upfront costs on servicers, including the cost of training agents in key behavioral principles and scripting changes. However, our behavioral training sessions are only one day long. Agents may also spend more up front time on the

phone with each borrower and therefore be able to handle fewer loans at a given time. Still, as a result of applying the behaviorally-informed modification process, we anticipate that the time it takes borrowers to submit an application will be shortened, and that fewer borrowers will be making in-bound calls with questions about next steps. Furthermore, in the long-term, servicers are expected to observe an increased number of modifications completed in shorter time frames, fewer foreclosures, and decreased modification redefault rates, all of which result in cost-savings for the mortgage firm.

## VI. What's Next?

Implementing a behaviorally-informed loan modification process requires a significant level of customization at the servicer level. A “one size fits all” approach will not work here, as each mortgage servicer employs unique procedures and has carefully cultivated relationships between borrower clients and employee agents.

Agents must be trained to understand key behavioral principles and to use adjusted scripts when communicating with borrowers. Servicer policies and procedures must be adapted to facilitate a streamlined process for both borrowers and agents. Our behaviorally-informed modification process is inherently scalable, but the full package of details must be implemented properly to avoid behavioral missteps.

With the right customization and execution, we believe that our behaviorally-informed modification process has the potential to add value for mortgage servicing firms across the industry. ideas42 is open to partnering with a mortgage servicer company to test the concepts in our behaviorally-informed modification process in a pilot. We anticipate that our findings are applicable across the mortgage industry and beyond, and can ultimately lead to quicker, easier resolutions and increased financial stability for distressed borrowers. □

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# Appendix

## Details of the Standard Modification Process

### Outreach

The goal of front-end collections is to obtain a promise-to-pay from the borrower. In most mortgage service operations, a borrower starts getting collections letters and calls when they approach 30 days past due on a payment. Call frequency can be high, with several calls every two to three days. Most servicers use automated dialers, and often borrowers talk to a different agent on every call. This means that borrowers will be asked to verify their personal information on each call, which is not only time-consuming, but could also be perceived as lack of engagement on part of the servicer. This impression could be exacerbated by the fact that agents are not likely to inquire into borrowers' reasons for financial distress, making the collections process quite impersonal.

When a borrower nears 60 days delinquency, and no promise-to-pay has been secured, the servicer sends a letter announcing the imminent start of foreclosure proceedings. If the borrower is reached, the focus of the interaction shifts to trying to understand the source(s) of financial distress that have caused the delinquency. At this stage, loss mitigation specialists take over communication with the borrower to evaluate the possibilities for a workout plan. Still, for the most part, borrowers are talking to different agents on every call, which could lead to inconsistent information across agents.

### Application

The first step in the application process is for a

loss mitigation specialist to review the borrower's financial situation over the phone. The financial information received is then used to evaluate the borrower for different workout options. The US Treasury Department mandates that all borrowers are considered for a Home Affordable Modification Program (HAMP) first.

After being aggressively targeted with collections calls, borrowers might be inclined to treat the loss mitigation agents with reserve at best. This could result in borrowers withholding information or trying to "game the system." Some borrowers tend to exaggerate their financial hardship in hopes of increasing their likelihood of obtaining a modification. Others hide the troubling aspects of their financial situation, thinking that admitting financial inadequacy will have a negative effect on their application. Both strategies could disqualify borrowers from obtaining a modification. For example, in the first case, borrowers could disqualify themselves if the financials they report do not pass the net present value (NPV) test, which determines whether it is more beneficial for the lender to modify the loan rather than foreclose on the property.<sup>11</sup> The majority of borrowers are not aware of the evaluation criteria for obtaining a modification, and many end up disqualifying themselves from being considered for one in the financials-gathering stage by over-selling or under-selling their distress.

Even if borrowers make it through the financials-gathering stage, the modification application process provides ample opportunities for further dropouts. The application forms are long, complex and confusing, and borrowers get little support from the servicer in filling them out. Besides, borrowers need to provide extensive documentation with the application – proof of income, comprising two recent pay stubs for employed borrowers, tax returns for the past two years, and proof of hardship including specific details on the nature of the financial distress. The document requirements are cumbersome and create plenty of opportunities for error, especially since

<sup>11</sup> Borrowers need to have a certain level of income to ensure they can make their modification monthly payments.

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servicers generally provide little support through the documents-compilation stage.<sup>12</sup> Once all documents are completed, they need to be notarized before being sent to the servicer for review, which adds yet another administrative hurdle to the process. The complexity and lack of support through the modification application invites procrastination on the side of the borrower, which often results in borrowers dropping out of the process altogether.

### **Post-Modification**

Depending on the servicer, it can take two to four months to review a modification application. After approval, for most modification types, borrowers are enrolled in a three-month trial period. If borrowers are current on their payments at the end of the trial period, then a permanent modification agreement is executed and rolled out into effect. Most servicers do not continue follow-up with modified borrowers after that point, even if they fall behind on their payments.

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<sup>12</sup> This is in sharp contrast to the mortgage origination process whereby a mortgage broker walks the customer through all of the documentation and continually updates them on their status.

# Standard Loan Modification Process

