Guidehouse

Have You Checked What's Lurking Under Your Roof?

Managing Risk in Home Equity Lines of Credit

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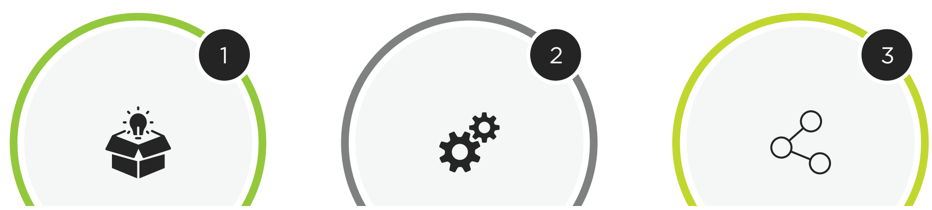
Real estate secured loans are still the lowest cost of borrowing, but Home Equity Lines of Credit (HELOCs) are facing increasing competition from new entrants (e.g., FinTech), substitutes (e.g., personal loans, point-of-sale financing, cash-out refinance), and other forms of credit (e.g., student loans, auto loans). Additionally, recent regulatory scrutiny and class action law suits against banks have highlighted the risks in servicing HELOCs. Such risks relate to (1) the nature of the product design, (2) initial account setup and account onboarding aspect of servicing transfers, and (3) ongoing servicing challenges. Banks looking to successfully grow their HELOC loan portfolios should aim to simplify the overall product design, implement automation and automated controls during account setup / onboarding, and institute efficient data governance throughout account servicing.

The HELOC market comes with significant risks



Product Design

- Complex HELOC contracts and amortization method
- Ambiguous contract language for key attributes

Account Setup

- Contract to system setup and reconciliation
- Servicing transfers and data-mapping issues

Ongoing Servicing

- Ongoing monitoring of key attributes and milestones
- Incident tracking and management

HELOC is the only form of household debt that has not resumed growth since the financial crisis.[2] Student loans, auto loans, FinTechs, and substitute products are taking up a larger share of borrowers' wallets while HELOC servicing challenges persist at some banks. To stay competitive, leading banks are proactively addressing and combating the key HELOC risks identified below.

1. Banks such as Citibank, Citizens Financial Group, J.P. Morgan Chase, and Wells Fargo have faced HELOC related lawsuits in recent years.
2. https://www.newyorkfed.org/medialibrary/media/research/staff_reports/sr882.pdf.

Product design

HELOC contracts are traditionally designed to meet borrowers' different repayment preferences and risk profiles. However, offering a wide variety of repayment methods oftentimes leads to ambiguous contract terms and nuanced conditions embedded in HELOC contracts. Such complex contract language can lead to borrower confusion and friction in the lending process and result in loans being incorrectly setup on servicing systems, increasing the risk of erroneous amortization. Depending on the product design, there could be dozens of different scenarios for interest charge calculations along with numerous different amortization methods available for total payment due calculations. What could make product design more intricate is the cross-dependence between loan attributes and the transition from draw period to repayment period. For example, late fee and annual fee calculation methodologies usually vary based on credit limits and vary from draw period to repayment period. This adds complexity during the interpretation and setup of the contracts on servicing systems.

Account setup

Boarding newly originated loans or loans transferred in from other institutions poses several challenges to servicers. These challenges are heightened for HELOCs given their contract complexity. This type of risk occurs because of (1) manual processes coupled with lack of documentation for setting up contractual information on servicing systems and (2) lack of effective controls for ensuring accurate and consistent contract interpretation by the account setup team.

There is potential for errors in the onboarding of HELOC accounts acquired from prior servicers due to insufficient controls for reconciling system setup with contractual language. Based on Guidehouse's experience, there is usually a data mapping and / or data quality issue discovered during data transmissions resulting from acquirers mapping the incoming account portfolio directly into their servicing system without performing system to contract reconciliation. As these accounts may have potentially been setup incorrectly at prior servicers, acquirers map over incorrect account and transactional data points and fields into their servicing system. The incorrect data points and fields can potentially lead to erroneous amortization of the borrower's account causing financial harm to the borrower.

Ongoing servicing

A HELOC account setup on the servicing system has several critical data points. These include draw and repayment periods' amortization codes, end of draw date, draw period extensions, and maturity date among several others. These are key risk areas that need to be monitored for consistent and accurate account servicing. Lack of controls for monitoring these fields can result in erroneous servicing of accounts and cause financial harm to borrowers. Without proper data governance in place, there is also the risk of inconsistent usage and interpretation of account and transactional data among internal parties, particularly for loans undergoing loan modification, foreclosure, and bankruptcy, thereby exposing accounts to a heightened risk of inaccurate servicing.

Top five actions to take to mitigate risk

Leading banks are taking a proactive approach to identify and mitigate risk elements within their existing HELOC portfolios and investing in technology and automation to reduce their risk exposure as they continue to originate and acquire HELOC loans. Based on Guidehouse's experience, the below examples show how to improve risk management for HELOC portfolios.

Simplify and Standardize Product Design

Standardizing product attributes and amortization methodologies, as well as simplifying contractual terms, can improve consistency, reduce borrower confusion and process friction, and reduce risk during account setup and processing. Lenders should limit principal and interest calculation methods while ensuring the financing needs and risk profiles of borrowers are not compromised. Furthermore, lenders should consider providing guidelines to account setup teams for interpreting contractual terms and regular training.

Strengthen Data Governance around Servicing Transfers

Industry leading firms are increasingly investing in data governance capabilities for better monitoring data quality and identifying process gaps. And such program and relevant insights generated are especially crucial to the quality of servicing post transfer. Oftentimes, the change of servicer disrupts key aspects of account servicing and results in a need for massive account setup and data mapping. A data governance program, with data dictionary and KRIs as components, allows management to monitor and oversee the transfer process and timely identify and resolve issues related to billing schedule, payment calculation, escrow analysis, loan modification application, etc. The proven benefits also include better loss mitigation performance and lower complaint volume which both indicate a more seamless and satisfactory customer experience.

Automate Contract to System Reconciliation

Automating and streamlining the entry of contractual information into servicing systems and system to contract reconciliation is critical to minimizing errors in account setup. Automation tools such as Optical Character Recognition (OCR) and Robotic Process Automation (RPA) have proven to be efficient and effective in digitalizing existing paper-based processes and automating the repeatable manual processes of capturing and transferring contractual data into serving systems. Overall, automation reduces the risk of incorrect data transfer and data misinterpretation during routine system to contract reconciliation.

Implement Intelligent Controls

Automated preventive and detective controls in the form of early warning systems with rapid feedback loops can flag, validate, and address potential operational risks throughout the loan lifecycle. For example, machine learning tools can scan through large files of customer transactions and allow firms to identify critical data points that are not consistent with contractual information. Such tools can identify accounts that are amortizing incorrectly, based on an analysis of a borrower's outstanding balance, contractual amortization method, payment behavior, and repayment terms.

Develop Policies, Procedures, and Training

Policies, procedures, and training are effective methods to guide analysts for identifying and addressing observed discrepancies in account servicing. Formal data governance policies and procedures coupled with adequate training can aid in identifying critical data points and fields that may indicate potential red flags in account servicing. For example, customer complaints often serve as red flags and help discover potential systemic servicing issues impacting borrowers' accounts.

How Guidehouse can help?

Guidehouse specializes in operations strategy and transformation, regulatory compliance, risk management, and data governance and analytics. We have executed large, complex engagements including account / loan level reviews, process improvements, internal control design, and risk assessments. Guidehouse is the only firm to complete the Independent Foreclosure Review mandated by the OCC. As part of previous HELOC engagements, v has:

- Assessed HELOC portfolios to identify root cause of erroneous amortization of borrower accounts.
- Examined HELOC portfolios acquired from prior servicers and/or prior servicing systems for accuracy and completeness.
- Conducted restitution and system corrections for HELOC accounts incorrectly set up on servicing systems.

If you have concerns regarding the amortization of your HELOC loans, plan to acquire or recently transferred in a HELOC portfolio from other servicers, or would like to conduct a quick sanity check to ensure that your HELOCs are serviced appropriately, kindly reach out to us for additional insight and guidance.

"Banks need to proactively manage lending and servicing risks to profitably grow their HELOC portfolios. By focusing efforts on product design, account setup, and ongoing servicing, banks can reduce confusion and friction in the lending process for borrowers to compete with new entrants, substitutes, and other forms of credit while reducing servicing risk."

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About Guidehouse

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