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Start-Up's Goal: Spot Trouble Before Loans Default

■ BY MARC HOCHSTEIN

If the businesses Tony Ettinger helped start in the 1990s are loan doctors, the venture he is now building could be called a provider of preventive medicine.

In an interview last month, Mr. Ettinger described his vision of a mortgage and nonmortgage loan servicer that would specialize in identifying borrowers in trouble and work out a modification or repayment plan before they default.

Today's market presents "the biggest opportunities in the credit space I've ever seen," because the explosion of untested products behoove servicers to keep tabs on the borrowers regularly, he said.

In 1996, Mr. Ettinger founded C-Bass LLC with veterans of Citicorp Securities' mortgage-trading desk. The bond insurer Enhance Financial Services Group Inc., where Mr. Ettinger was an executive vice president, put up half the capital; the Milwaukee mortgage insurer MGIC Investment Corp. put up the other half.

C-Bass set out to buy and collect on mortgages that were, or had been, delinquent, using sophisticated pricing models to find assets the market was undervaluing.

Two years later Mr. Ettinger set up another New York joint venture between Enhance and MGIC: Sherman Financial Group, which pursued a similar, technology-based strategy, except it bought unsecured consumer debt like charged-off credit card and Chapter 13 bankruptcy receivables. Radian Group Inc. of Philadelphia bought Enhance in 2001, and Mr. Ettinger retired.

Ettinger: Lenders "haven't brought the rocket scientists" into servicing.

He expects consumer credit quality to worsen over the next two years, particularly for the riskier products that have mushroomed recently, like subprime loans and interest-only and adjustable-rate mortgages.

"Small shocks in the credit system could mean big shocks in the performance" of such products, he said. "It's not like prime borrowers, who have more reserves to keep paying through a problem."

In Mr. Ettinger's view, servicers of mortgages and other consumer loans are ill prepared for the coming deterioration in credit quality; though lenders have invested heavily in analytical tools for originating loans and collecting on bad debt, they have not brought the same sophistication to servicing performing loans. "They haven't brought the rocket scientists on to the servicing side."

Technology could help firms predict which borrowers are headed for default, he said. For example, "most people pay in fairly regular patterns" — they tend to mail their checks around the same time each month. If they start paying later than normal, "there's usually a reason," and a servicer's systems could track such patterns and alert the company to deviations.

Gleaning such information is one thing; acting on it is another.

Kathleen Tillwitz, an analyst at Fitch Inc., said it is "awkward" for a servicer to contact a borrower in good stead on the basis of an updated credit report, let alone a predictive behavioral score.

People who are current on their loans typically "don't want to hear from their servicer," she said. "Not many servicers are going to make that call." But she agreed that more of them should.

Mr. Ettinger said his servicer would "need to be careful" about approaching borrowers who have not defaulted but have given it reason to believe they will do so. It would make a "courtesy call" in which it would say it noticed some changes in payment patterns and ask, "Is everything OK? … Is there anything we can do to help?"

The idea is that "the more contact you have with an at-risk borrower, the more chances they have to talk to you," he said.

He also made a more controversial assertion about servicers: Even when a troubled borrower takes the initiative of calling, as long as the loan is current, "they treat it like a prime loan and try to minimize contact with the borrower."

In his observation, the standard operating procedure is to simply tell these borrowers to do their best to pay. Only when the customer becomes delinquent a few months later is the typical servicer willing to counsel them or negotiate a modification or repayment plan, and by then there are fewer options for working out the loan, he said.

"The key … is to try to work with that borrower as soon as they have a problem, when they've got more flexibility and they still have money," Mr. Ettinger said.

But Ms. Tillwitz said that when borrowers call to warn of problems, most of the servicers that Fitch rates will research the situation and, if warranted, negotiate a repayment plan, a loan modification, or a home sale.

John LaRose, the chief executive of CompuLink Corp., the Lansing, Mich., subservicer that does business under the name CeLink, said that such a call "would cause us to go into a whole different level of communication." It would want to know "as much as … [the borrower] is willing to share."

For example, if the borrower were getting divorced, CeLink would try to learn things like the date the divorce is final and whether the spouse would assume the mortgage, he said.

Enhance acquired small servicers and contributed its interests to C-Bass and Sherman (to which it also contributed an analytics firm). Mr. Ettinger said the new servicer would also be built with small acquisitions. Servicing is "not a business line that lends itself" to starting from scratch.

Ratings are important, and the rating agencies look for a track record, he said.

Unlike in 1996, Mr. Ettinger does not have an insurance company with nearly $1 billion of assets behind him this time. Credit-Based Capital, the Chappaqua, N.Y., firm he started in August, is close to securing private equity capital for its first purchase, he said.

He is banking on the track record of his creations. Last year C-Bass and Sherman produced $147 million of profits for MGIC, 23% more than they did in 2004, and $136 million for Radian, or 20% more than they did in 2004, according to the insurers' annual reports.

Also, unlike C-Bass' Litton Loan Servicing LP and Sherman's Allegis Servicing, which service primarily loans owned by their respective parents, the new company would work for third parties.

However, Mr. Ettinger said it would share some of the credit risk by investing in the residual pieces, to show "we're putting our money where our mouth is." ■

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