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Buyers of non-performing loan valuations should focus on risk management and due diligence.

Even though defaults continue to decline as property values stabilize, the non-performing loan market remains active. Naturally, along with these loan sales, comes a shift in assuming the inherent losses. NPL purchasers are increasingly becoming the custodians of the mortgage industry's most volatile risks.

Investors and hedge funds, whose primary focus is distressed debt, are the unsung heroes of the industry. Purchasers of NPLs work with servicers to reduce risk and loss severity, and work with borrowers to make every attempt to keep them in their home. If foreclosure is unfortunately inevitable, investors will seek strategies to allow the homeowner a dignified exit.

In order to manage this risk and ensure fiduciary responsibility to investors and their shareholders, traders must rely heavily on accurate valuations to make the right decisions. Many times these valuations come in the form of broker price opinions, most fulfilled by nationwide providers relying on local licensed real estate brokers and agents.

Considering that market modeling and loan pricing are essential to the process, getting an accurate value and understanding what that represents is fundamental.

What follows is a deeper dive into these two

areas, along with some key questions and topics that an investor should consider when selecting a BPO partner.

There are two key questions to ask when looking for a NPL valuation provider:

1. WHAT CONSTITUTES A SOUND BUSINESS?
Identify potential providers: Select the right partner based on experience, credibility, financial strength, stability and compliance.

2. WHAT CONSTITUTES SOUND BUSINESS PRACTICES?
Choose the best provider: Validate processes, quality, timeliness, communication, technology, and audits.

IDENTIFYING A PROVIDER

NPL Experience

The NPL market is vastly different than servicing or origination and investors need a partner who knows their business needs and can fulfill those needs quickly and accurately. The investor should understand the provider's experience with NPL BPOs, as volume is a strong indicator of their prowess and credibility in that area. Due to the enhanced risks that come with NPLs an investor needs to be able to trust the BPOs they are assessing to be accurate. When a trusted provider is used, the seller and bidder are more comfortable with their pricing. This reduces the scrutiny a bidder needs to apply to the property valuations and contributes to the confidence that enables successful deals.

Credibility - Third-Party Validation

Selecting a vendor that has received a high rating from a reputable third-party is one more level of assurance that the BPO provider is "who they say they are." A third-party assessment can substantiate claims of sound operational infrastructure, as well as the existence of sufficient security protections. The evaluation will also verify procedural consistencies and assess technological proficiency. These assessments will generally evaluate a provider's pending legal cases or past due payments. If the third-party evaluator is a company the industry trusts (e.g. Morningstar, SSAE), the vetting process can be reduced or avoided all together, resulting in quicker on-boarding of the provider. This validation adds credibility to an investor's valuation provider and most importantly its valuations. Valuations that are viewed as credible will result in smoother processing when buying or selling pools. This credibility will also help to narrow the list of the top valuation partner candidates. The final selection can then be made based on which firm best aligns with the investor's business strategies and goals.

Financial Strength and Stability

The housing industry is cyclical, and it is important to have a vendor that has experience and staying power through any market cycle. Part of the initial evaluation process should include a review of the company's financials. Vendors are managing significant responsibilities on behalf of their clients, specifically the ability to pay their network of real estate agents in a timely manner, as well as the carrying the cost of receivables over time. Some questions to consider include whether the provider is a small firm, operating locally, regionally or nationally and whether they are publicly or privately held.

Smaller, private firms may present greater risk over time, given the cash flow requirements of providing BPOs, especially with the increased compliance regulations and technological resources needed to remain competitive. Often times, larger companies have more liquidity and healthier balance sheets, which provide better counter-party risk. Additionally, publicly held companies sometimes provide an additional layer of risk mitigation given their compliance with Sarbanes-Oxley and Dodd-Frank. The bottom line is that the BPO provider, whether a small mom and pop or a Fortune 500 corporation, should provide the investor with confidence that it has the financial strength and history to sustain its offering and client relationship through a dynamic and risky market.

Track Record of Internal Audits, Oversight and Controls

Just as an investor would not want to be a babysitter of its employees, it certainly does not want to constantly monitor and hold the hand of its valuation partner. Investors benefit from partnering with companies experienced with both internal and external audits. Providers with extensive auditing history will be much more equipped to accommodate any future or specialized auditing that an investor requires. In addition, the provider should have historic audit records on file to demonstrate to an investor that they are a BPO partner with tight controls that are stringently followed.

Compliance

Compliance is obviously an important matter and is referenced throughout this article. An additional factor of compliance is the awareness of regulatory changes. Investors need a partner who is always up to date on the current regulatory requirements ranging from a county level, state level, to a national level, ensuring that all regulations are met.

CHOOSING A PROVIDER

Operational Expertise and Industry Reputation

If the potential valuation partner has the right talent and training, then operational expertise and excellence will be apparent. The mortgage industry is vast but it is also a tightly knit community where reputations are key and networking is common. Through countless industry events, investors will easily see the most active players in the NPL space, but this visibility does not necessarily represent high quality. Investors want a partner that is well versed in the market and, as validation, may use these events to talk with real estate brokers that complete BPOs. These conversations will often yield important insights into the mindset and practices of several providers. Investors should seek a valuation provider with a positive industry reputation and with credibility with agents, because this generally indicates that they keep their client's best interest in mind.

Talent Acquisition and Continuous Training

Having the right talent in place is critical for any business and that is no different when looking at valuation providers. Investors should seek partners who understand the business and their needs, and this knowledge must filter down to the staff level. Sound recruiting and continuous training processes ensure the team who will support the business has both the expertise and the support in place to provide accurate and timely results. Additionally, companies with well-established talent acquisition processes and training programs generally have more engaged employees that perform at the highest level.

Agent Panel Management

Ultimately, a BPO report is completed by a real estate agent with expertise in the subject's specific market. However as history has proven, quality and accuracy vary widely. It is up to the BPO provider first to identify and recruit talented local experts, ensure they are trained on client requirements, and then motivate and retain the strongest performers. Robust metrics, scoring of results, and close management of the panel will ensure the most qualified agent is being selected for each asset. A valuation provider should be able to assign agents based on attributes that correlate with strong NPL valuation performance. Just as an investor needs to partner with a BPO provider that is seasoned in the NPL world, an investor should want their valuation provider to select agents who are experienced with performing BPOs for NPLs. Leaving the agent selection process to chance can mean the difference between being able to sell non-performing assets at the best price available or losing money on the sale.

Communication, Quality Control, and Technology

Communication and quality should start even before order placement. Companies have a multitude of needs, deadlines, and goals when ordering on NPL pools and providers must be able to flex with changing requirements. Investors should make a site visit and speak with operational team leaders to assess their knowledge and motivation. Investors should also assess whether operations has access to real-time metrics for ongoing performance management and if this front-end support shares the investor's sense of urgency. Examination of the quality control review process is crucial, as this is arguably the most important driver of overall quality. A best practice for any provider is the ability to match clients' reports with reviewers who are expert in the NPL space.

The QC review will provide the highest level of accuracy by confirming that the subject and comp data matches the most viable local source such as the Multiple Listing Service. Given today's regulatory scrutiny, it is crucial that BPO providers have access to national MLS information. BPO providers without MLS access will likely struggle to match the data of the subject property with that of comparable properties and may therefore have compliance challenges and/or other downstream problems. QC should also ensure that the investors' guidelines have been met and that a narrative has been provided outlining any discrepancies, variances, or nuances of the subject and its market. Investors should ask potential partners about the percentage of BPOs that are reviewed by an internal valuation specialist(s) and learn if there is automation technology in place to accurately highlight discrepancies, which decrease the likelihood of human error. Find out how often the platform is updated and what specific examples the provider can show where technology has improved critical functions like operations and quality control. The assessment of operational excellence is a key to conducting a thorough evaluation of a provider.

Technology Applications and Infrastructure

While technological capabilities play an important role in the due diligence of choosing a provider, the security of data must also be evaluated from a risk stand point. Investors should understand the provider's business continuity and disaster recovery plan and learn how often this plan is updated. The provider should also have surge capacity if multiple clients have simultaneous and therefore competing projects. Investors need to ensure that providers are consistently able to perform their work and are not constantly fighting major technological outages. Investors should also inquire about information security protocols and specifically determine if their provider's SSAE 16 certification is in place. Lastly, investors should ask for the most recent audit findings/report in order to determine whether the provider is compliant with the latest guidelines.

It is important to keep in mind that the aforementioned best practices are only meant to be a guide as opposed to a comprehensive list.

While the NPL market has slowed some, it is will remain an important part of the overall mortgage industry in the coming years. As trends have shown, NPLs will likely grow again, possibly surpassing the 2011 volume levels. Selecting a strong valuation provider is a key to success, so NPL investors should closely examine these risk management and due diligence factors, and choose a provider who will not only meet current needs but will be the best partner in the future.

The bottom line is that the BPO provider, whether a small mom and pop or a Fortune 500 corporation, should provide the investor with confidence that it has the financial strength and history to sustain its offering and client relationship through a dynamic and risky market.