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In search of new markets, IBM taps ... subprime mortgages?

Big Blue plucks assets of servicing firm in midst of the subprime meltdown

By John Letzing, MarketWatch

SAN FRANCISCO (MarketWatch) -- International Business Machines Corp. has been many things during its century-long history: Purveyor of meat slicers and weighing scales, record-keeper for a brand-new U.S. Social Security system, and maker of personal computers, to name a few.

But one of the newest incarnations for Big Blue, supporting the servicing of relatively risky, subprime home loans, presents a unique opportunity to profit from a dubious segment of the mortgage industry.

IBM (NYSE:IBM) announced its acquisition of Wilshire Credit Corp.'s assets and employees from Bank of America Corp. (NYSE:BAC) in October.

According to data from SourceMedia, Wilshire ranked 15th in terms of subprime loan servicing volume in the U.S. as of Sept. 30, at an estimated $21 billion. Terms of IBM's purchase of Wilshire were not disclosed, and IBM doesn't expect the deal to close before the first quarter of 2010.

IBM said in a statement at the time that Wilshire's servicing rights would remain with Bank of America. However, industry observers are unsure about the technology giant's precise plans for integrating Wilshire, which has been privy to both the significant upside, and ugly downside of the subprime loan business.

Subprime loans triggered a credit crunch in 2007, which grew into last year's global economic meltdown. The loans generally involve higher interest rates, but are also made to borrowers considered more at risk of defaulting. Following years of boom times, a cascade of defaults helped put credit markets into a deep freeze, from which they're only now starting to emerge.

Mortgage servicers collect payments, assess penalties and make modifications - reducing monthly installments, for example. Though generally insulated from loan defaults, servicers also do the dirty work of foreclosing on homes. Wilshire is named as a defendant in several civil lawsuits, alleging that it played a role in predatory lending schemes.

"There's a lot of litigation risk" in servicing mortgages, said Mark Calabria, director of financial regulation studies at the Cato Institute. "I have to assume [IBM's] general counsel's office has gone through this, and is comfortable."

An IBM representative declined to comment for this story.

However, the company's acquisition of Wilshire enhances its ability to benefit handsomely from an upswing in mortgage servicing. A wave of modifications is anticipated, as subprime borrowers in dire straits seek out help. That in turn could create new demand for data and analysis, which IBM could address with its technology.

From backwater to the spotlight

Earlier this year, Wilshire was slated to oversee $366 million courtesy of the federal government's Making Home Affordable program, an initiative meant to help clean up the subprime mess by subsidizing more modifications.

According to data released by the White House earlier this month, more than 700,000 mortgage modifications are underway, though only about 31,000 have so far been converted by servicers to "permanent" status.

With the sudden and pressing need to essentially re-do hundreds of thousands of loans, the formerly sleepy business of mortgage servicing has been pulled into the spotlight.

Mortgage servicing was seen as a "backwater" prior to the real estate boom and bust, the Cato Institute's Calabria said. Now, however, there is increasing demand for technology that could help make smarter decisions about which mortgages to modify, and to what degree.

"You want to try to get some indication of who you need to call, before you get in trouble," Calabria said.

Paul Leonard, director of the California office of the Center for Responsible Lending, said that as more distressed homeowners seek modifications, market players will naturally seek better and faster infrastructure. "The servicing industry has been struggling to keep up with a tsunami of activity," Leonard said.

IBM's interest in loan modifications predates the Wilshire acquisition. In March, the company announced an offering that enables servicers to quickly process requests, for example, and it has offered technology outsourcing to the mortgage industry for years.

But with Wilshire, IBM is acquiring the assets of an entity that's become a conspicuous target for irate homeowners.

Wilshire has been named as a defendant in dozens of lawsuits filed in the past two years. In a fairly typical suit filed in U.S. District Court for the Southern District of California in August, homeowners in San Marcos allege that their "usurious" loan was knowingly based on inflated income, and came with undisclosed finance charges.

The plaintiffs claim "severe emotional distress," and damages in excess of $500,000. They argue that the defendants' conduct "amounted to malice," and note that their home was slated for a foreclosure sale.

While the underwriting of such subprime loans are now "virtually non-existent," the body of existing loans still needs a lot of work, said TowerGroup analyst Craig Focardi. In addition, IBM could now expand Wilshire's assets to cover less-risky home loans, Focardi said.

"Given IBM's IT assets and mortgage expertise, they've got the ability to expand the capabilities of the Wilshire platform to prime credit loans," he said.

Wilshire was acquired by Merrill Lynch & Co. in 2004, and then inherited by Bank of America as part of a hasty merger between that firm and Merrill Lynch amid the chaos of last year's Wall Street meltdown.

The Wilshire acquisition "further demonstrates IBM's commitment to delivering robust and innovative mortgage solutions during a difficult time for the mortgage industry," IBM said in a statement in October.