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The Rising Cost of Mortgage Loan Servicing

Industry considerations in an environment of
rising costs and shrinking margins



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Introduction

Changes in regulatory and compliance legislation are creating disruption in the mortgage servicing industry, and the implications of that disruption are having significant financial consequences.

The inflated infrastructure costs arising from the procedural compliance burden associated with recently enacted legislation are causing Servicers to re-think their target operating models. Satisfying newly created National Servicing Standards and sustaining profitability is a disruptive reality. This paper outlines the disruptive changes caused by market dynamics and the regulatory changes enacted in January 2014, and enumerates a handful of recommendations to help servicers achieve improved profitability.

Regulatory Disruption

New legislation and the rulemaking that has come in the wake of the Dodd Frank Wall Street Reform and Consumer Protection Act (DFA) is the biggest catalyst creating disruption in the marketplace. In April 2012 the U.S. Department of Housing and Urban Development (HUD), the HUD office of the Inspector General, the Department of Justice, a number of state Attorneys General and state banking regulators, and the nation's five largest servicers reached a \$25 billion settlement to address Servicer accountability for consumer financial consequences associated with the default crisis. The settlement was originally only applied to Bank of America, Wells Fargo, JP Morgan Chase, Citi and Ally/GMAC. However, it surfaced the need for more rigorous standards, policies and procedures for all servicers. Joseph A. Smith, Jr., the former North Carolina Commissioner of Banks was chosen by the government to oversee the conformance of the five servicers to the terms of the settlement. He stated from the beginning that he would recommend national standards that would be applied to all servicers.

In January, the Consumer Financial Protection Bureau, created and charged with rulemaking and regulatory oversight by DFA, began enforcing a set of newly defined rules for national servicing standards that amended Regulation X, the Real Estate Settlement Procedures Act (RESPA), and Regulation Z, the Truth in Lending Act (TILA). These standards created standard compliance requirements, policies and procedures, all subject to CFPB audit, enforcement and punishment:

1. Periodic billing statements;
2. Adjustable-rate mortgage interest-rate adjustment notices;
3. Prompt payment crediting and payoff payments;
4. Force-placed insurance;
5. Error resolution and information requests;
6. Information management policies and procedures;
7. Early intervention with delinquent borrowers;
8. Continuity of contact with delinquent borrowers; and
9. Loss mitigation procedures.



Downsizing Trends

Basel III increased capital and reporting requirements may be contributing to the downsizing of "mega-portfolios" held by large lenders and their servicing operations. If considered in conjunction with previously mentioned disruptive forces—reduced profitability, operational risk for non-compliance with new federal standards among them, the trend of larger "Mega" servicers transferring servicing

rights to specialty servicers and smaller sub-servicers is predictable. A prevailing assumption is that niche sub-servicers have specific and unique specialized competencies, the appropriate institutional scale, and the intrinsic flexibility to deliver compliant services economically and efficiently for consumers.

RANK	COMPANY	LOCATION	2013Q4	2012Q4	CHANGE
1	Wells Fargo & Company	San Francisco, CA	\$1,829,450	\$1,872,791	-2.3%
2	Chase	Iselin, NJ	\$1,017,167	\$1,101,905	-7.7%
3	Bank of America	Charlotte, NC	\$810,532	\$1,332,380	-39.2%
4	CitiMortgage, Inc.	O'Fallon, MO	\$395,683	\$452,009	-12.5%
5	Nationstar Mortgage	Lewisville, TX	\$390,707	\$207,814	88.0%
6	Ocwen Financial	West Palm Beach, FL	\$276,899	\$314,321*	-12.0%
7	U.S. Bank Home Mortgage	Bloomington, MN	\$275,677	\$257,055	7.2%
8	PHH Mortgage	Mt. Laurel, NJ	\$226,837	\$183,730	23.5%
9	Walter Investment Management Corp.	Tampa, FL	\$198,828	\$90,094	120.7%
10	Cenlar	Ewing, NJ	\$163,169	\$105,270	55.0%

*2012Q3 volume

Source: http://mortgagestats.com/residential_servicing/



Implementation Challenges

Implementation and compliance for the nation's servicers has proven complicated and expensive. Lenders are more experienced with compliance obligations to multiple jurisdictions and investors within the origination and production side of their businesses. Servicers have traditionally experienced less regulatory and compliance constraints, and therefore have less dedicated and experienced infrastructure in place to monitor compliance. That implies new cost, with subject matter expertise that comes at higher and higher salaries.

The traditional dichotomy between the loan production (origination) and loan administration (servicing) business functions is also contributing to implementation challenges. TILA, RESPA, and other compliance policies typically associated with front-end loan production standards are amended to ensure customers are appropriately notified and communicated when loan circumstances change. This front to back accountability for loan performance, borrower disclosure and status communication implies functional integration between origination and

servicing platforms that is distinct from the manner in which banks maintain their current operating model. Mortgage functions are often operated and managed separately within the bank's infrastructure. Loan administration and default servicing can be delegated to third party sub-servicers or component servicing outsourcers. Strict third party management standards of accountability have been enacted as part of the National Servicing Standards implementation to ensure that lenders remain in control of performance outcomes regardless of the operating model.

Servicing operating models are designed to capitalize on ever increasing economies of scale to achieve profit targets. Traditional servicing businesses interact with the vast majority (97 percent) of its borrowers with computerized billing and automated envelope openers. The new rules require that servicers incorporate more "high touch" services that cannot be leveraged as high transaction automated functions. The new standard requirements for addressing delinquency requires the maintenance of a

core infrastructure that will be more expensive than legacy operating models. Single Point of Contact (SPOC) is an example of a new layer of infrastructure that is required going forward. This fixed cost infrastructure is inverse to the high volume, high transaction, low cost activities to administer performing loan functions.

Compounding matters is that the servicers are subject to regulatory compliance requirements beyond CFPB's rules. Fannie Mae and Freddie Mac have both updated their servicing requirements, requiring servicers to respond more quickly to borrowers who miss a payment in order to mitigate potential losses. They are even looking at changing the way servicers are compensated in order to change their behavior.

Emerging Talent Deficit

Perhaps the most difficult aspect of retooling America's mortgage servicing shops for full compliance is the policy requirements attempt to protect the interests of both the investor and the borrower. This dual advocacy creates a tension that can put servicing executives in between conflicting enforcement priorities. Talent retention within the industry has proven challenging. Managing through the credit crisis took its toll on leaders within the industry. Years

of dealing with an avalanche of troubled borrowers, intense regulatory and investor pressures and lengthy work weeks has created significant executive burn-out. In addition, as budgets tighten, servicers can no longer afford the salaries required to retain high performing senior executives. Many executives are leaving the industry to pursue careers outside of residential mortgage, where the scrutiny of federal regulators and investors is less intense.

Increasing Cost of Servicing

The cost to service a loan is rising. According to MBA's Servicing Operations Study, prior to the credit crisis, it typically cost servicers an average of \$55 per loan per year. Today, experts estimate the cost to service at \$208 per loan per year or more. The cost to service non-performing loans is rising too, such that it now costs 4 times what it cost to service a delinquent borrower just 4 years ago.

Servicers have invested to implement the operational measures required to be compliant with regulatory and investor change requirements. These actions have been expensive and have ongoing sustainability costs as well. There is evidence to suggest that the threat of non-compliance with standards and the changes implemented by servicers are benefiting the consumer.

For example, there are reports of servicers pro-actively calling on non-delinquent customers that haven't made their payment by the due date, even if the grace period has not yet expired, to avoid the costly loss mitigation process.

Controlling Costs and Increasing Revenue

1. Labor Arbitrage

Servicers can perform a comprehensive job task analysis to determine elements of their operation that can be outsourced to third party specialists who have the scale, global delivery capability, and specialty expertise to perform operations more efficiently. Having internal teams collaborate with outsourcing teams helps servicers acquire an objective perspective on their operations, allows them to integrate best practices, and improves the quality and consistency of operational delivery.

2. Technology Upgrade

Automation is a means to reduce time and create operational efficiency and higher productivity. Removing human resource requirements from processes that can be automated reduces expense and frees servicer personnel for required customer engagement roles. Employing technology that allows borrowers to self-service also reduces fixed costs. The borrower-facing portals utilized in mortgage technologies are not as advanced as consumer transaction portals in other industries. The upgrading of these interface technologies is an

opportunity. Borrower surveys indicate a strong interest in self-service inquiry for concerns such as "when is my next payment due" and "have you received my property tax bill."

In today's highly regulated environment, leading servicers are deploying technology to provide compliance checks at every borrower touch point. A number of systems are now available that will provide the knowledge base and the transaction monitoring required to prove compliance in the case of an audit. In line quality control is a premise of most modern manufacturing environments, and it significantly reduces re-work, time and expense of corrective actions.

3. Cross-Sale Innovation

As the owner of the on-going borrower relationship, increasing a bank's share of wallet through the marketing of incremental banking products and services offers potential value. Cross selling can be a bank's golden opportunity, but too many miss out.

According to Affinion Group, a company that specializes in customer engagement, seventy percent of all customers share their banking needs with more than one financial institution. Customers are using anywhere from two to six different financial institutions in the same community and rarely use the same bank for more than two services.

In order to gain market share, banks need to use available data, along with advanced analytics to understand all customer segments. Servicers who are proactively monitoring their portfolio and using analytics to better understand customer's buying behaviors can proactively approach a borrower about refinancing their existing loans. Tapping into the Bank's customer information system can also inform servicers of certain consumer actions that may indicate a home purchase is in their future.

Instead of waiting for customers to come to them, Banks need to establish a digital ecosystem that will insert them into everyday customer interactions and allow them to become involved in the flow of their customers' digital lives.

Summary

Even in this age of increased regulatory oversight, mortgage loan servicing remains a business in which scale increases profitability. The servicers that succeed will be those that establish organizations that are capable of scaling and creating economies of scale that generate sustained profits. Labor cost management, technology and innovation are essential to improving operational efficiency and labor productivity. Low cost operators will be able to invest in alternative revenue generating initiatives. Servicers looking for a more detailed road map are encouraged to contact us.

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