

Mortgage Servicing Takes Center Stage

by Paul T. Peterson

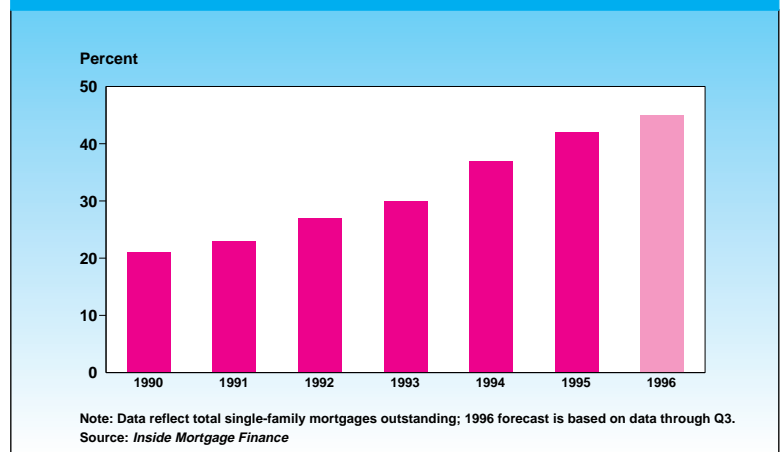
IN A FEW SHORT YEARS, mortgage servicing has shifted from a back-office operation into one of the more dynamic and visible actors on the residential-finance stage. Servicing¹ has come into its own as a distinct business enterprise, capable of generating far greater profits than in the past and eager to take advantage of new technology to reduce loan administration costs.

The focus on servicing could not have come at a more auspicious time, given a number of factors that have changed the face of the industry in recent years. To start with, a considerable consolidation has taken place within the business. At the midpoint of 1996, the 30 largest mortgage-servicing companies collected and redistributed the cash flows for a record 44 percent of the total single-family mortgage debt outstanding in the country compared to only 21 percent six years earlier (*Exhibit 1*). This trend has accelerated more recently as an unprecedented number of acquisitions and mergers has led

¹See glossary on page 13 for definitions of words highlighted throughout the article.

Paul T. Peterson is senior vice president of Freddie Mac's servicer division.

EXHIBIT 1: Market Share of Top 30 Servicers



to an even greater concentration of servicing in the hands of a few companies. For instance, Norwest Mortgage Inc.'s recent acquisition of Prudential Home Mortgage's servicing portfolio makes Norwest the country's largest servicer with \$176 billion in servicing as of September. Norwest now administers 4.6 percent of the country's mortgage debt payments. The merger between Chase Manhattan Bank and Chemical Bank and the purchase of FBS Mortgage's servicing portfolio by BankAmerica earlier in 1996 added to the industry's consolidation. At least three other major deals are on the horizon that should raise the market share of the top 30 to at least 45 percent early in 1997.

The evolution to relatively larger servicing portfolios allows businesses to take advantage of economies of scale. It also concentrates decision-making into fewer hands, creating more compelling incentives and a greater ability to reduce costs and manage business risks.

Keeping an Eye on Costs

At the same time, the risks born by servicers have increased. The combination of the current low-interest-rate environment and the wide variety of refinancing programs offered by lenders has given borrowers additional reasons to refinance, an action which increases the variability of servicing income streams. Even the accounting process for the profession has changed the

competitive landscape for servicers. A new accounting rule from the Financial Accounting Standards Board (FASB) requires that all servicing rights, whether acquired by purchasing the rights or as a result of originating a mortgage, appear separately on the servicer's financial statement. Furthermore, the servicing must be valued at the price for which the asset would sell currently on the open market as opposed to the previous practice, in many cases, of reporting the value at the price for which the asset was originally acquired. This introduces yet another element of volatility to a servicer's balance sheet, as the value of servicing rights fluctuates over time with interest-rate changes. Given this new accounting treatment, many servicers are buying hedges to offset the volatility of the balance sheets, further straining company bottom lines.

Yet taken as a whole, these recent changes have placed servicing in a more pivotal role within a lending organization, particularly with respect to the ability of this business line to make significant additions to corporate profits. Mortgage servicing will continue to occupy center stage as the industry responds to ever-changing market conditions and opportunities.

Fine Tuning Servicer-Investor Interests

The marketplace works best when the incentives of servicers

The marketplace works best when the incentives of servicers and investors are in alignment.

and investors are in alignment. Servicers derive their income from standard servicing fees (typically 25 basis points for a conventional loan amount and 44 basis points for government loans) and the float from the short-term interest they earn on loan payments before remitting the funds to investors. Both of these income sources vary with mortgage prepayments, which occur when the mortgaged property is sold (voluntarily or to avoid a default) or the loan for the property is refinanced.

Servicer costs consist of the overhead of managing payments and the added costs of dealing with borrowers delinquent on their loan payments. These latter expenses in particular can prove quite large and variable. As a rule, for example, mortgages that become seriously delinquent

(with arrearages left unpaid for 90 days or longer) cost servicers about \$1,000 in general administrative and property-inspection fees, as well as the loss of float interest on the monthly loan payments.

Servicing managers intent on maximizing profits have kept a keen eye on borrower prepayments and defaults. Investors, too, share an interest in the reduction of default costs as well as the management of prepayment and default risk. Each foreclosure, for example, costs an investor anywhere from approximately \$2,400 to \$5,000 in carrying costs from losses in interest and foreclosure-related expenses. Consequently, there must be a recognition and alignment of incentives; for servicing managers are compelled to produce solid results for their own organizational bottom lines, while investors at the same time find it essential to protect their assets and interests.

The recent industry changes have, however, affected the risks and incentives of both servicers and investors. As noted previously, prepayment risk has increased for both parties. On the other hand, recent technological advances have also increased the ability of both sides to limit the costs and risks of default. Finally, the increased consolidation of the servicing business has more finely sharpened the incentives for servicing managers due to the

EXHIBIT 2: Quarterly Servicer Performance Profile

Performing Loan Criteria¹	Weight	Tier 1	Tier 2	Tier 3	Tier 4
Cash Shortage	25%	0 day	1–10 days	11–20 days	>20 days
Shortage Percentage	25%	0%	>0–≤10%	>10–≤25%	>25%
Transactions in Error	15%	≤.01%	>.01–.06%	>.06–.50%	>.50%
Applied Transactions Errors	20%	≤2%	>2–5%	>5–7%	>7%
Late Payoffs Reporting	15%	0%	>0–2%	>2–4%	>4%
Default Management Criteria²					
90-Day + Transition Rate	20%	≤2%	>2–≤6%	>6–≤11%	>11%
Workout Ratio	45%	≥45	<45–≥36%	<36–≥25%	<25%
Troubled-Loan Workout Rate	5%	≥25%	<25–≥18%	<18–≥12%	<12%
Delinquency/Foreclosure Timeline (no delays)	11%	0 days	1–22 days	23–45 days	>45 days
Delinquency/Foreclosure Timeline (with delays)	11%	≤20 days	21–77 days	78–130 days	>130 days
Late REO Reporting	3%	≤1.25 days	>1.25–≤2 day	>2–≤2.5 days	>2.5 days
Foreclosure Inventory	5%	≤5%	>5–≤7.5%	>7.5–≤10%	>10%

Note: Some row headings have been simplified and condensed.

Source: Freddie Mac

¹**Cash Shortages** measures average number of days per month in which a cash shortage of more than \$1,000 exists between what Freddie Mac is owed and receives. **Shortage Percentage** measures accuracy of remitting practices by determining sum of each day's shortage amount as a percentage of the total due Freddie Mac for the month. **Transactions in Error** reflects ability to provide accurate investor reporting information, expressed as number of loan transactions with errors as percentage of total number loans reported. **Applied Transaction Errors** measures promptness in clearing up reporting errors through the percentage of incorrect transactions that continue to appear on a Freddie Mac transactions report for 60 or more consecutive days. **Late Payoffs Reporting** determines timeliness with which borrower loan payoffs are reported, measured as number of payments reported more than five business days after payoff date.

²**90-Day + Transition Rate** gauges effectiveness of early default management/collection efforts, expressed as number of 30-day delinquent loans over a three-month period that subsequently become 90 days or more delinquent or enter foreclosure as a percentage of total 30-day delinquent loans. **Workout Ratio** measures effectiveness of loss-mitigation efforts determined by number of workouts as percentage of opportunities for workouts. **Troubled-Loan Workout Rate** measures loss mitigation effectiveness as number of workouts settled as percentage of loans that become 90-day delinquent or enter foreclosure over a six-month period. **Delinquency/Foreclosure Timeline (no delays)** measures foreclosure processing effectiveness as the duration from the last paid installment until the foreclosure sales date on each loan going to foreclosure sale in past 12 months. **Delinquency/Foreclosure Timeline (with delays)** is same as previous gauge but measures effectiveness in eliminating or reducing foreclosure delays by including sales with acceptable delays, such as bankruptcy, for example, in calculation. **Late REO Reporting** measures average number of days that a foreclosure sale is reported late. **Foreclosure Inventory** measures percentage of loans currently in foreclosure that exceed the Freddie Mac state-by-state standards.

highly competitive nature of the business. A growing awareness of these impacts has prompted the mortgage industry to work harder still to better align incentives and reduce costs for all the participants.

Rewarding Performance

Freddie Mac has introduced a number of ground-breaking products and services to aid in reaching this objective. Earlier this year, Freddie Mac completed work on a performance measurement tool, unique to the mortgage industry, that assesses a servicer's performance, provides corresponding feedback and then links incentives to the success a servicer has experienced in achieving the desired loan-management and activity results. This tool, called the "Servicer Performance Profile" (*Exhibit 2*), looks at management practices separately for **performing** loans and **nonperforming** loans, while measuring and monitoring the operational performance of the servicer in both areas. Delinquent-loan management practices are further analyzed in terms of collection and **workout** procedures, as well as foreclosure timelines. Based on this weighted information, a servicer is classified as performing at one of four levels.

A Tier 1 designation gives definition to what Freddie Mac considers superior servicing performance. Tier 1 servicers exceed performance expectations

Freddie Mac has begun entrusting some riskier mortgage business solely to top servicing performers.

by consistently forwarding borrower payments to the investor on time with few or no errors. If remitting errors do occur, the servicer rectifies them immediately. Tier 1 servicers also excel in early default management and collection efforts by heading off foreclosures through the pursuit of repayment and workout alternatives. Tier 1 servicers also handle the foreclosure process, when necessary, with a maximum of efficiency.

Tier 2 servicers also meet Freddie Mac's servicing standards. Although Tier 2 servicers do well with workout efforts, they do not exhibit the same efficiencies in time management and accuracy as do Tier 1 servicers.

In recognition of the top levels of performance, Freddie

Mac has revised the incentive plans offered to servicers when mortgage workouts become necessary. For example, compensation for a **short payoff sale** is based on a fee schedule. Under the revised program, Tier 1 servicers receive the highest compensation based on evidence that they successfully managed the delinquency process from beginning to end. Tier 2 servicers receive the next highest compensation and so on. For each loan a servicer works out or reinstates through a loan modification, Freddie Mac saves an average of \$26,000. For each loan that is diverted from **REO** through a short sale, Freddie Mac avoids an average \$17,000 outlay.

In addition, Freddie Mac has begun entrusting some riskier mortgage business solely to top servicing performers in an effort to limit the company's exposure to unnecessarily high loan losses. For example, Freddie Mac's 3-percent down-payment mortgage purchase program, unveiled last fall, requires a Tier 1- or Tier 2-ranked company to perform the servicing duties on the low-down-payment loans.

Servicers who fit into the Tier 3 and Tier 4 categories fall below

When timing is everything and insider expertise may be in short supply, outsourcing can solve problems quickly.

Freddie Mac's performance expectations, with the latter producing unacceptable results, placing investor assets at risk.

Attention to Quality Control

Freddie Mac looks at servicers falling in the bottom two tiers as an opportunity and is working with these companies to elevate their performance status.

Consequently, Freddie Mac is providing training and resources to these companies, enabling them to develop and implement steps to improve performance and reduce investor risk.

Typically, servicers struggling to manage their delinquent loan portfolios may find that contracting out loss-mitigation activities achieves desirable results. When timing is everything and insider expertise may be in short supply, outsourcing can solve problems quickly and relieve the burden of updating in-house computer systems, reallocating resources or quickly hiring and training staff. Freddie Mac supplies an outsourcing service, launched last year, to augment the loss-mitigation efforts of some servicers who either are not performing at a satisfactory level or who are working with a sizable portfolio of defaulted mortgages.

The effort that goes into these resources can pay off in quantifiable ways. Through the intervention of Freddie Mac-approved outsourcing contractors

Business as Usual:

No matter what changes ripple through the servicing industry in the years ahead, servicers will continue to perform their traditional default-management role.

A half dozen years into the recovery from the 1990 recession, the first signs of significant improvements in mortgage delinquencies, which lead to investor credit losses, are now appearing (see *Exhibit 1*).

One of the primary drivers of credit losses lies with the demise of rapid house-price appreciation that once provided a cushion against the inevitability of many defaults. In the 1970s and 1980s, house prices were appreciating at an average 7 percent a year. That meant a typical house doubled in value within 10 years.

In recent years, house-price appreciation in some parts of the country has slowed to 3 percent, at best. At this rate, it would take a little more than 23 years for the value of a typical home to double. Consequently, today's slower rate of equity build-up in a home does not provide the same strong incentive for borrowers to rule out foreclosure as a solution to their financial problems.

Losses have also risen due to the recent misfortunes of California, a state accounting for nearly one-quarter of the country's outstanding mortgage debt. Property values there have dropped as the state went through a recession from which it is now starting to emerge. Likewise, borrowers have struggled with the effects of natural disasters throughout the state, such as the Northridge earthquake, mud slides and fires, further adding to investor credit woes.

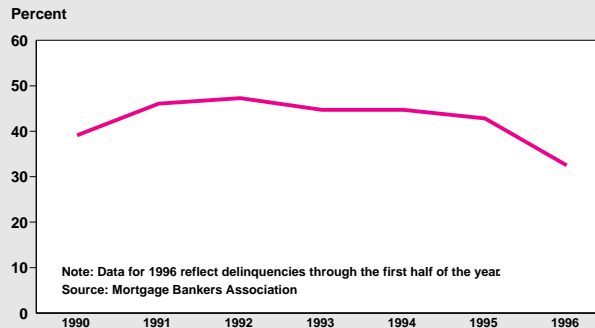
Foreclosure Work Remains Vital

In 1990, for example, Freddie Mac and Fannie Mae together absorbed nearly \$0.5 billion in shortfalls arising from the failure of sales proceeds from repossessed properties to pay off the balances remaining on defaulted mortgages. Now, after climbing steadily for the past four years, the 1996 combined credit-loss figure for the two companies will reach just over an annualized \$1.05 billion based on first-quarter figures, according to Freddie Mac estimates.

Additionally, differences in state laws have led to some prolonged delays in the time it takes to foreclose on a home in certain states. That further exacerbates the credit-loss problem for investors, as property carrying costs mount over time. To manage these differences, Freddie Mac earlier in the year published state-by-state timelines identifying reasonable time frames for the completion of foreclosures. In New York, for example, a foreclosure—from initiation to the sale of the property—should take no longer than 336 days. In contrast, a foreclosure sale in Texas should draw to a close within 58 days, given that foreclosures there can generally be settled out of the judicial system, thereby avoiding the delays that result from filing a court action, getting a court date, fulfilling legal-notice requirements and obtaining a ruling.

Over the past two years, Freddie Mac has begun working with servicers more aggressively to decrease the percentage of delinquent loans going to foreclosure by intervening as soon as a borrower gets into trouble. For every 100 loans that become

EXHIBIT 1: Conventional Mortgages 90+ Days Delinquent



delinquent by 90 days or more, Freddie Mac estimates that approximately 25 loans will pay off because the owner sells the home or refinances, 25 will reinstate or become current and 14 will move to a less serious state of delinquency. The remaining 36 loans will result in foreclosure sales if nothing is done. Therefore, Freddie Mac is encouraging servicers to pursue alternatives to foreclosure whenever appropriate.

Even as servicers work hard to clear up the current crop of loan defaults in their servicing portfolios, the need for foreclosure management shows no signs of abating for some time to come. The large book of new-purchase and refinance business written during the low-interest-rate days from 1992 to early 1994 will cycle into the historic period for peak defaults from now until 1999. Even though most of these loans represent the lowest probabilities of default, the tremendous volume alone may translate into a large number of delinquencies and defaults. In addition, the most recent books of business originated in 1994 and 1995 are generating higher default and foreclosure rates than typically seen at this point in

time in the mortgage life cycle. During these years of origination, lenders made an unusually large number of low-down-payment loans to borrowers in weaker credit positions in order to preserve their loan production volume.

All in all, the long-standing foreclosure side of the mortgage business is not about to disappear from a servicer's plate any time soon.

—Paul T. Peterson

Technological advances are making it possible for servicers to respond sooner to a mortgage that becomes delinquent.

to handle loss-mitigation activities, **workout ratios** have become significantly higher. Each loan that reaches REO constitutes an average \$44,000 loss to an investor, according to Freddie Mac estimates.

Eventually, though, Freddie Mac will take a harder look at its relationship and business ties with servicers unable to climb out of the bottom tier.

Capitalizing on Technology

Technological advances in the form of consumer behavior models and analytical decision-making tools are making it possible for servicers to respond sooner to a mortgage that becomes delinquent and to then target their resources to those homeowners needing the most help.

A new Freddie Mac software tool, PaymentProspectorSM, assigns a probability factor as to which borrowers that are 16, 30, 60 and 90 or more days delinquent are the most likely to **cure**. Armed with this information, servicers can focus their efforts on borrowers most likely to go to foreclosure without more intensive servicer involvement beyond sending out borrower notices of delinquency. To make its prognoses, PaymentProspector statistically identifies and weights key loan attributes (such as loan-to-value ratios and property values) and borrower payment patterns (such as loan payment histories) to determine whether

the loan will pull out of default on its own. The delinquent-loan management tool was developed using data from many systems, including Freddie Mac's own automated underwriting system, Loan Prospector[®].

In the loss-mitigation area, WorkoutProspectorSM, provides another tool of recent vintage that helps servicers determine the best foreclosure alternative for a borrower. Based on servicer-supplied data on the borrower, including monthly household expenditure and income information, Freddie Mac and the servicer assess the cost and borrower benefits of various workout options. The probable impacts of a **repayment plan**, a **loan modification** or a short payoff sale are then weighed against the likelihood and cost of the loan going to foreclosure and the property passing into Freddie Mac's REO inventory.

Playing to Ovation

Freddie Mac remains committed to helping servicing companies perform to the rave reviews of their peers as the spotlight shines brighter on this part of the mortgage industry. In particular, Freddie Mac is convinced that servicers and investors can thrive in mutually beneficial arrangements as long as they share a common interest in practicing proactive loan management and, most importantly, striving for measurable standards of servicing excellence. **SMM**