The Recent Woes of Non-Bank Mortgage Servicers

(And How They Should Respond)

White Paper

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Introduction

Non-bank mortgage servicers have grown by leaps and bounds since the crisis. As they have become an integral part of the American dream of home ownership, they have also attracted increased scrutiny from the government. In order to sustain their recent growth, non-bank servicers should invest in improving operational effectiveness, build in tighter controls, and align their organizational goals with that of the regulators.

Post-crisis Growth of Non-bank Servicers

Before the financial crisis of 2008, servicing of loans was a relatively straight forward process. Loan modifications and foreclosures were relatively rarer. However, in the wake of the crisis, entire portfolios went delinquent and Mortgage Servicing Rights (MSR) prices dropped to almost nothing (dropped by 70%)[1]. Soon thereafter, lenders recognized the need for low-cost non-bank servicers.

This trend was mainly because handling a large volume of distressed loans required increased borrower interaction, either for modifications or foreclosures. Traditional banks neither had the manpower nor the infrastructure. The financial crisis also brought the banks in the crosshairs of the regulators, not to mention the general public. Both these factors forced the banks to sell their servicing rights to non-bank servicers in large numbers.

The introduction of Basel III capital requirements has made it very difficult for the bank servicers to hold MSAs (Mortgage Servicing Assets) beyond a certain limit. This is because Basel III requires bank servicers to hold dollar-for-dollar capital against any MSAs in excess of 10 percent of the bank's Tier I common equity which is a narrower category than the Tier I capital.[2] As a result the bank servicers (especially the smaller banks) would be forced to sell off a significant portion of their current MSAs to non-bank servicers who have no such regulations imposed on them.

[1] *Time to fix US Mortgage Market, Absalon Project, absalonproject.com*

[2] *US Basel Final Rule: Visual Memorandum, Davis Polk & Wardwell LLP | 450 Lexington Avenue | New York, NY 10017*

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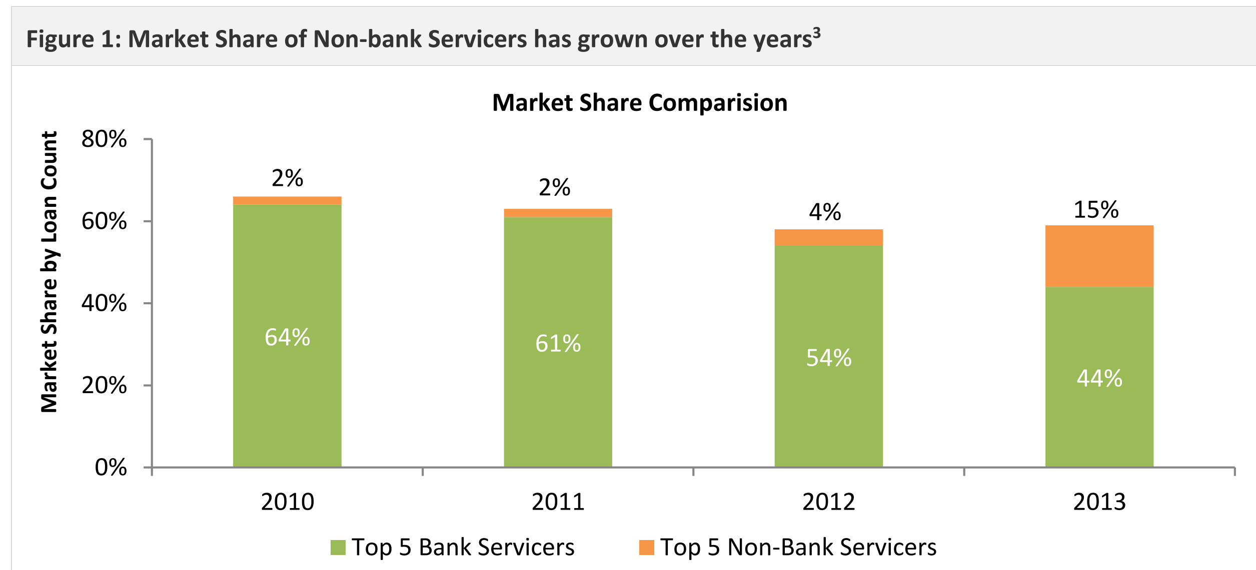
To wit: all of the top 10 mortgage servicers in 2010 were banking institutions. Compare this to 2014, when 5 of the top servicers are non-banks. Figure 1 shows how the market share has changed hands over the years in favor of non-bank servicers:

Figure 1: Market Share of Non-bank Servicers has grown over the years[3]



[3] *Inside Mortgage Finance and Housing Finance Policy Center Commentary, Urban Institute*

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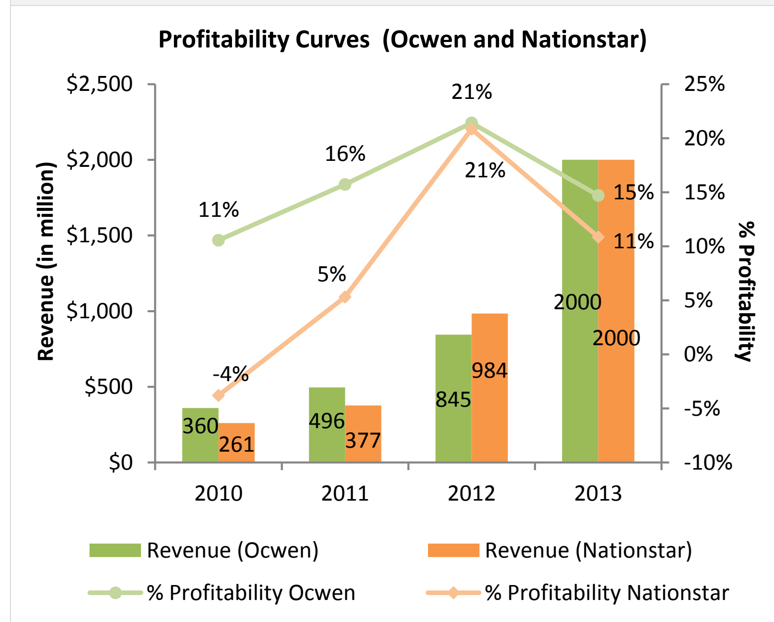
Non-bank Servicers – Recent Troubles

"Questionable Business Practices"

The abandoned Wells Fargo and Ocwen Financial deal is a reflection of the attitude of regulatory bodies towards the non-bank servicers. Wells Fargo announced in January'14 that it would be selling servicing rights to Ocwen Financial to service loans worth $39 billion. However shortly after the announcement, the office of Benjamin Lawsky (superintendent of New York's department of Financial Services) halted the transaction which was ultimately abandoned. Lawsky cited *"One of the things we're concerned about as a regulator is whether these (mortgage-servicing rights) sales trigger a race to the bottom that puts homeowners at risk. The cheaper a servicer can service those mortgages, the more profit it expects to earn from the fixed servicing fees, and the more it can offer the banks to buy these MSRs. The result is high prices paid for MSRs, together with incentives for cut-rate servicing by non-banks."* Lawsky also wrote in a notification to the firm that the 30-day period in which the borrowers could challenge the denials *"had already elapsed by the time they received the backdated letter."*

The servicers have not only grown extensively, but have also generated significant returns for their investors. Ocwen, in fact, made it to the top-100 fastest growing companies list in the year 2014[4]. Figure 2 shows the exponential rise of profitability[5] for Ocwen Financial and Nationstar, two of the largest non-bank mortgage servicers.

Figure 2: The profitability of Ocwen and Nationstar has grown over the years[6]



A lot of this has been achieved through more effective operations (migrating certain processes to lower cost economies, better loss mitigation, etc.), although detractors also claim that non-bank servicers have been quick to foreclose on their borrowers and have been operating on shoe-string capacity.

[4] *http://fortune.com/100-fastest-growing-companies/ocwen-financial-8/*
[5] *Profitability = (Net Income)/(Total Revenue)*
[6] *Ocwen Financial Report, March'13*

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The regulators have sat up and taken notice. The task of regulating non-bank servicers has mostly been the prerogative of individual states, there has been a variation in the intent and extent of oversight. This has further exacerbated the apprehensions among the Federal regulatory bodies like Department of Financial Services (DFS) and Federal Housing Finance Agency's Office of Inspector General (FHFA OIG). The concerns of these regulators are as follows:

- **Aggressive foreclosures over loan modifications**: Regulators believe that non-bank servicers make more money by going for foreclosures rather than carrying out loan modifications. This is because of the poor incentive compensation which servicers get in a successful loan modification. Even the cash incentives to modify the loans through HAMP (the Obama Administration's foreclosure mitigation program) have not outstripped servicers' compensation incentives in the foreclosure process. Servicers are paid through a percentage of the unpaid principal balance on a loan. Since the most common and successful type of modification is direct reductions of the principal, these modifications directly cut the servicer profits by reducing the unpaid principal amount. Foreclosures on the other hand do not hurt the servicers, because they make back the money owed, along with all the fees in a foreclosure sale.
- **Illicit benefits due to Business Affiliations**: Non-bank servicers have business affiliations with other entities including providers of loan originations, securitizers, or foreclosure management firms. It is often believed by regulators that these affiliations incentivize the servicers to act in ways that are in the interest of allied companies. The non-bank servicers however, claim that these business alignments help to increase efficiencies for customers and investors.

"Self-dealing"

Recently, Lawsky questioned Ocwen's relationship with Altisource, itself a group of companies chaired by Ocwen's CEO, who is also the largest shareholder in the company. *"The relationship between Ocwen, Altisource Portfolio, and Hubzu raises significant concerns regarding self-dealing. In particular, it creates questions about whether those companies are charging inflated fees through conflicted business relationships, and thereby negatively impacting homeowners and mortgage investors," wrote Lawsky in a letter to the general counsel of Ocwen.*

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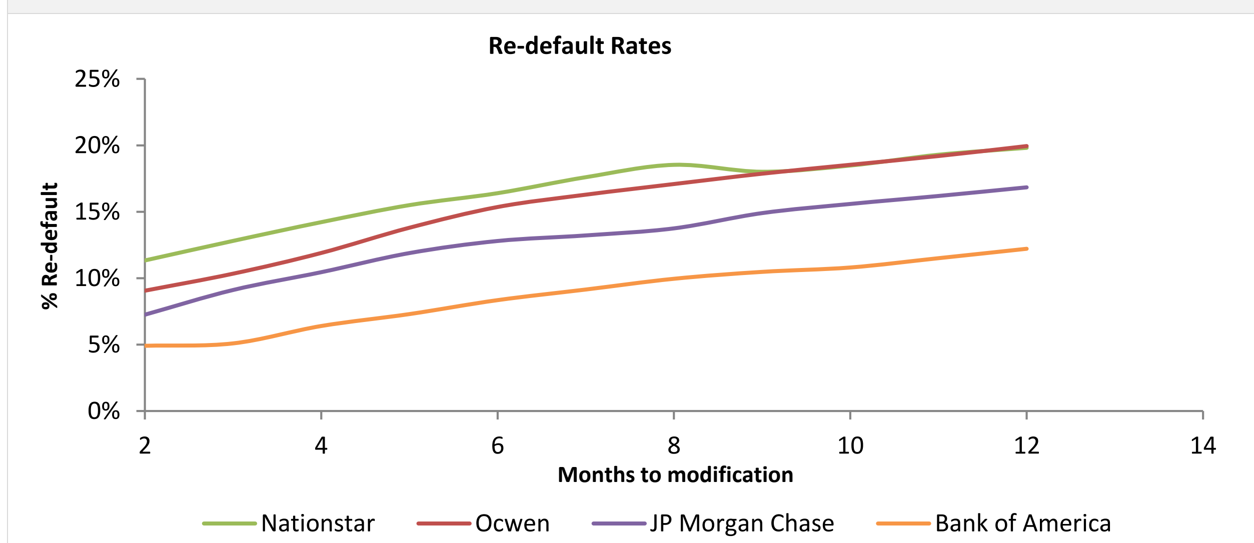
- **Recent increase in loans per employee:** In late 2010, bank staffing levels declined as distressed loans were resolved but the nonbank staffing levels increased due to rapid expansion of their portfolios. While the number of loans per employee decreased significantly for banks from 800 to 500 by 2012, it was noted that this number remained constant at 275 for non-bank servicers.[7] This shows that the non-bank servicers were increasing their staffing levels to keep up with the rapidly expanding portfolio. The ratio however grew in 2013 to 400 which became a matter of concern for regulators amidst fears of decreasing service quality.[8] As a result, FHFA advisory bulletin of Mortgage Servicing Transfer (AB 2014-06) listed out the following as operational risks: "*servicer capacity, taking into account staffing, facilities, information technology systems, and any sub-servicing arrangements*".

"Capacity Issues"

Lawsky also recently expressed concerns about hundreds of complaints received from New York consumers about Nationstar's mortgage modification processes, improper fees, lost paperwork and numerous other issues. Lawsky wrote in a letter that his departments has significant concerns that the explosive growth at Nationstar and other non-bank mortgage servicers may create capacity issues that put homeowners at risk.

- **Lower-quality and delayed loan modifications:** The quality of loan modifications carried out by non-bank servicers has been questioned. As Figure 3 shows, the re-default rates for Ocwen and Nationstar are worse than the top banks. While it is true that the portfolio that non-bank servicers manage are of a fundamentally poorer quality, but there is an additional concern: as Figure 4 indicates, the non-bank servicers *initiate* the mod trial at a later stage than their banking counterparts.

Figure 3: Re-default rates for non-bank servicers are higher than those for bank servicers[9]



[7] *Housing Finance Policy Center Commentary, Urban Institute*

[8] *Ocwen Financial however increased its staffing level by 104% from 5000 in 2012 to 10900 in 2013 while there was a 77% growth in the portfolio during the same period.*

[9] *Non-Agency Loan Modification Report: Servicer Comparison, August'14, Blackbox Logic LLC*

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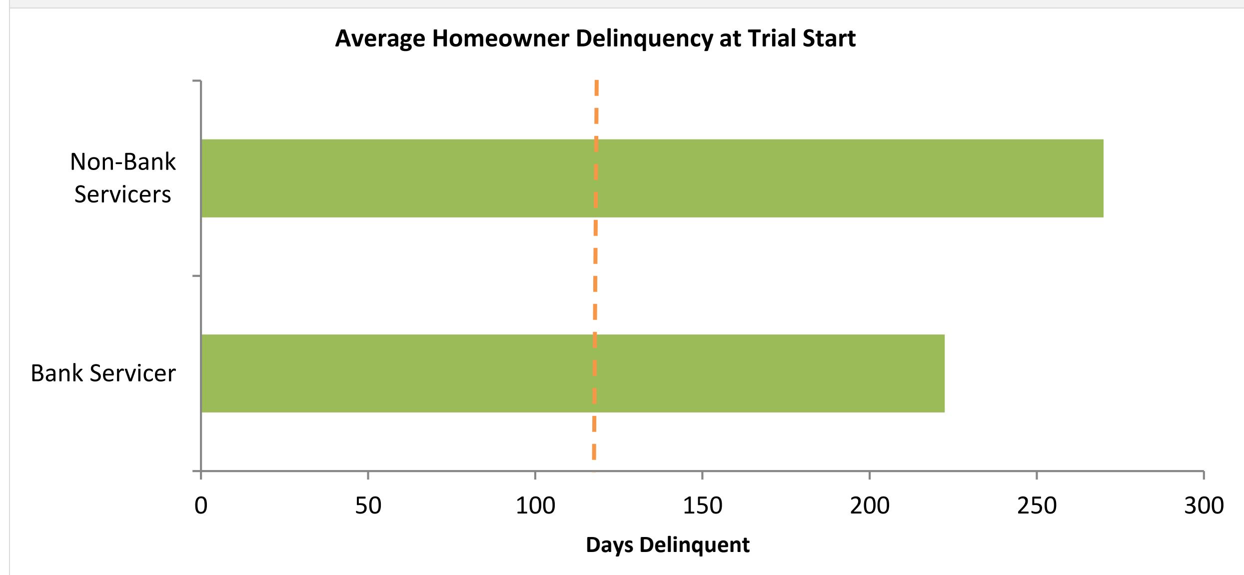
Figure 4: Both Bank and Non-bank servicers perform poorly from the timeline perspective in carrying out modifications



- **Disruptions due to Servicing Transfers**: The transfer of servicing rights from one servicer to another is a complex process. Since a majority of loans in these transfers are of distressed nature, it is highly probable that a large fraction of loans in loss mitigation are disrupted during the transfer and cause inconvenience to the distressed borrowers which are in the middle of a loan modification process, for one or both of two reasons (a) the two servicers do not cooperate with each other, and (b) the loan information is not transferred accurately in a timely manner. The regulators have also come out with guidance regarding servicing transfers[10], but they are nowhere enough.
- Financial and Operational Risks carried by Non-bank Servicers

  Absence of capital and liquidity requirements (e.g., Basel III) for non-bank servicers poses certain financial risks as well:

  - **Operational Risk**: As the complexity of the mortgage servicing business has grown, the risk of breakdown in the servicer's internal processes and systems has grown significantly. In fact, most of the "challenges" highlighted in this paper contribute, directly or indirectly, to operational risk. Key processes such as loan transfers, dealing with delinquent borrowers, and investor reporting, have all been found to be susceptible to procedural or systemic failure.

    The risk has been further exacerbated by recent upheavals in the industry. The topic of operational risk has not received as much managerial attention as it deserves. Few servicers have been able to undertake a thorough of their processes, highlight key risk areas, put in a robust controls framework, or develop high-level operational risk metrics. Inadequate Operational Risk Management can lead to regulatory intervention or sanctions thereby resulting in a direct financial impact.

[10] *Compliance Bulletin and Policy Guidelines: Mortgage Servicing Transfers, CFPB Bulletin 2014-01*

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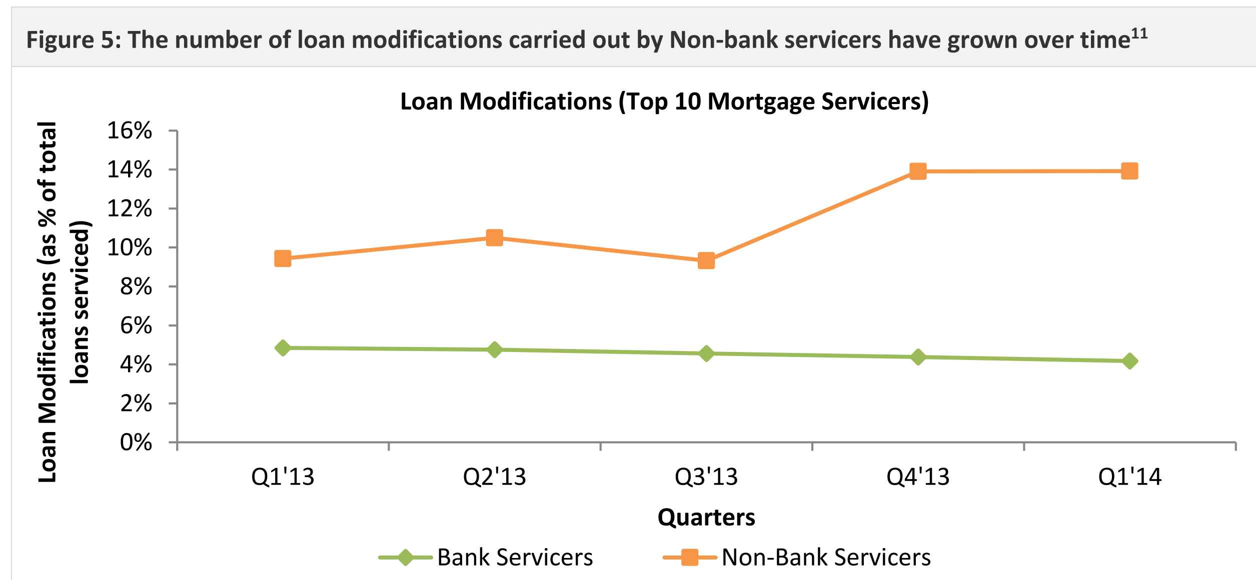
- **Liquidity Risk**: Liquidity risk rises if an asset or security cannot be traded quickly enough in the market to prevent losses. Insufficient liquidity can lead to operational problems for non-bank servicers. If a borrower whose loans are in a private label securitization (PLS) miss their payments, servicers are still responsible for advancing payments to the investor. These situations often force non-bank servicers to borrow money for short terms at high interest rates, if they do not have enough liquidity. Over a period of time, lack of liquidity can substantially raise the cost of servicing for a non-bank servicer

What should Non-bank servicers do to sustain their growth?

While non-bank servicers have taken the flak for compromising the borrower's interest more than traditional large-bank servicers, this picture may already be outdated. As Figures 5 indicates, the gap between loan-modification rates of bank and non-bank servicers bridged significantly in 2013. The complaint rates have also decreased over this period of time, as non-bank servicers have added capacity.

Figure 5: The number of loan modifications carried out by Non-bank servicers have grown over time[11]



However, given the generally poor quality of the portfolios that non-bank servicers handle, and their already-significant role in the mortgage industry, the regulatory pressure on non-bank servicers is here to stay.

[11] *www.mortgagestats.com and www.treasury.gov*

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We feel that servicers would do well to heed the following:

Enhancing Operational Effectiveness

Since the portfolio of non-bank servicers consists largely of distressed loans, they need to be fundamentally better at loss mitigation than their bank counterparts. Part of the solution lies in better capacity planning to do enough workouts each month, but the other part will be to invest in superior loss mitigation infrastructure.

The sophistication of modeling of loss mitigation decisions has so far lagged behind that of other retail banking models (compare them, e.g., with modeling for uncollateralized loans like credit cards, where even the smallest risk decisions are made through statistical modeling).

Managing Financial and Operational Risks

The financial risks discussed earlier have become a much more crucial piece in the current macroeconomic environment. These risks need to be mitigated through better MSR pricing and robust cash flow management. The federal and state regulators like Financial Stability Oversight Council (FSOC) are already considering the imposition of capital requirements on non-bank servicers[12]. Doing this will reduce the vulnerability of non-bank servicers to economic downturns and reduce the risks posed to the borrowers and investors. On the other hand, it will increase the costs of servicing to levels similar to their banking competitors.

Non-bank servicers should also be wary of using short-term finance to buy servicing rights for troubled mortgage loan pools that will yield returns only after a long-term, thereby exposing the servicer to severe liquidity crunch in case of a financial crisis. The following are the pillars of a robust liquidity management strategy:

- **Adequate and Appropriate Measurement**: In today's more complex funding environment, simple balance sheet ratios may not adequately reflect an institution's liquidity position. The requirement is for customized liquidity measurement models, based on specific liquidity risks arising from a firm's business model, operations and risk profile. However, implementation of liquidity measurement models will require servicers to significantly upgrade their data gathering and management information system (MIS) capabilities
- **Liquidity Stress Testing**: While planning for the liquidity levels, the non-bank servicers should account for all the difficulties they can face due to liquidity strain. The financial crisis of 2008 revealed that many financial institutions were financing long-dated, illiquid assets with short-term wholesale funding, and during the crisis, did not have adequate liquidity buffer to manage the payouts. In order to avoid this, we believe the firms should have an emergency funding plan for managing stress environments. The plan should be tested, reviewed, and updated at regular intervals to ensure its robustness and validity in an ever-changing market environment

[12] *http://www.americanbanker.com*

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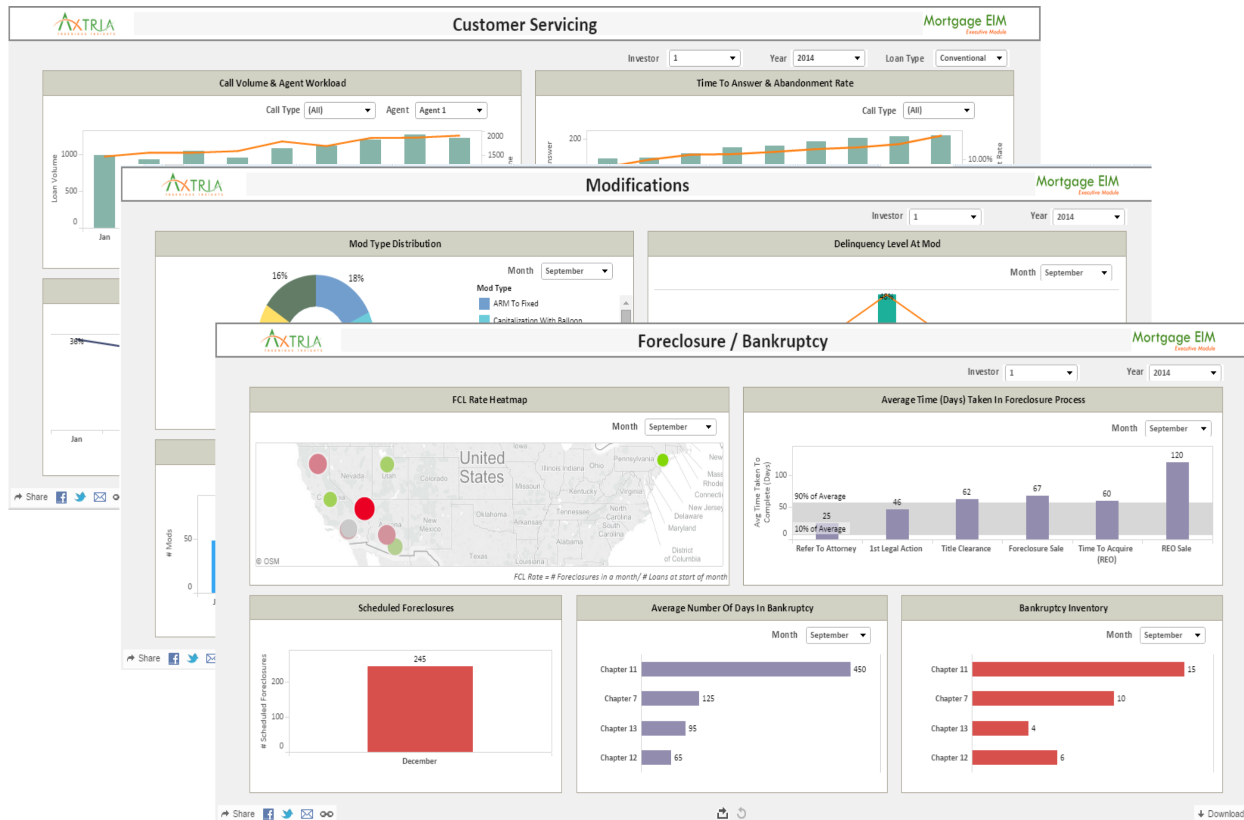
- **Enhanced Systems, Controls and Governance**: Operational Risk Management (ORM) involves identifying Key Risk Indicators (KRIs), quantitatively articulating loss levels for each risk and aligning the management decisions so as to mitigate these risks. Development and implementation of risk mitigation programs (for example, by automating controls and processes) can lead to a better ORM and ensure regulatory compliance of mortgage servicers.

In order to mitigate these risks the non-bank servicers would do well to copy the best practices of their banking counterparts, and make similar investments in data and technology infrastructure. At the same time, the liquidity planning should take into account the expected portfolio growth and future funding requirements.

Increasing Process Transparency towards the Regulator

There is no doubt that the non-bank servicers needs to strictly adhere to the standards set by CFPB by providing clear monthly billing statements, warning borrowers well in advance about interest rates hike, crediting people's payments promptly, swiftly correcting errors and keeping better records.

While meeting these requirements, the servicers should aim to bring in more transparency in their communications to the regulators than there has been in the past. This is difficult but not without its benefits. Latest advances in data aggregation and visualization will help servicers convince their regulators that they are knowledgeable of the issues, and are working to minimize them.



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Aligning the goals of Servicers and Regulatory Bodies

Finally, and most critically, we believe that servicing efficiencies and borrower centrism can improve only when both regulators and servicers are aligned in their goals.

The servicers should look to make their servicing practices as borrower centric as possible rather than merely adhering to the guidelines set by the regulatory bodies. The regulatory bodies on the other hand need to consider the development of regulations that improve the safety and soundness of this channel, rather than those that eventually become a bottleneck to growth. Ultimately the question regulators need to face is how to best encourage all servicers to perform optimally for borrowers, investors, and lenders, as well as for shareholders.

At Axtria, we have been helping our clients tackle these challenges through increased focus on mortgage process, controls and superior information management. If your organization is facing similar challenges, please check out our service offerings at *www.axtria.com*.

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