Intelligent Evolution

At the Mortgage Bankers Association's (MBA's) Commercial/Multifamily Asset Administration and Technology Conference in May, we presented case studies showing how a selection of commercial/multifamily servicers are facing the ever-increasing challenges of managing their shares of the $3 trillion in commercial/multifamily mortgage debt outstanding. What we found was a heterogeneous industry in which companies serve different mixes of investor groups, play varied servicing roles and even have different business objectives. Not surprisingly, the way in which each firm chooses to address its set of circumstances is also unique.

The business of commercial/multifamily mortgage servicing has become increasingly sophisticated and specialized. A series of case studies highlights the variety of business models being used.

BY JAMIE WOODWELL AND DIANA REID

The evolving market

Over the last two years, the commercial/multifamily finance market has been experiencing a perfect calm (see "The Perfect Calm," by James R. Woodwell, *Mortgage Banking,* January 2007). Those benign market conditions have been shaped by a confluence of improving property markets, widely available capital and real estate finance innovation, which together have fostered an unparalleled strength in commercial real estate finance.

During this period, origination volumes, property values and mortgage debt outstanding have all hit record highs. At the same time, mortgage delinquencies and cap rates have seen record lows. The result has been exceptional growth in both the size and sophistication of the servicing business.

According to MBA's *Annual Origination Volume Summation 2006* report, dedicated commercial/multifamily originators closed $406 billion in commercial/multifamily loans in 2006, a 10 percent increase from 2005 levels. This is on top of a 2005 level that was 50 percent higher than that of 2004. Significantly, both 2005 and 2006 levels saw increases in originations for nearly every investor group—from commercial mortgage-backed securities (CMBS) conduits to commercial banks and thrifts to life companies, Fannie Mae and Freddie Mac.

Strong origination volumes manifest themselves directly in increasing loan balances being serviced. At the end of 2006, MBA's analysis of the Federal Reserve Board's *Flow of Funds Accounts of the United States* data report showed $2.95 trillion in outstanding commercial/multifamily mortgages, an increase of $333 billion or 12.7 percent from the end of 2005.

Almost half of this increase was in commercial bank portfolios, and nearly one-third—$108 billion—came through growth in the balance of loans held in commercial mortgage-backed securities (CMBS), collateralized debt obligations (CDOs) or other asset-backed securities (ABS). The Fed data show that other investor groups also saw increases: life companies' mortgage holdings grew by 6.5 percent; Fannie Mae, Freddie Mac and Ginnie Mae multifamily mortgage pools grew by 7.6 percent; and mortgage real estate investment trusts (REITs) increased by 36 percent.

The Fed data show that approximately 80 percent of the $2.95 trillion in commercial/multifamily mortgages outstanding were held as whole loans by banks and thrifts, life companies, Fannie Mae and Freddie Mac (or their multifamily mortgage-backed securities), state and local governments and others. It also shows that, for the first time, more than one of every five dollars of commercial /multifamily mortgage debt outstanding was held in a CMBS or other private-label, asset-backed security.

The evolving industry

The changes taking place in the commercial real estate finance market have fueled changes in the structure of the industry itself. While the market has been undergoing changes in volumes, in sources of capital, in performance and in structures, so too have the firms that originate, process and service the loans.

A key driver of change within the industry has been a desire by firms to offer a full product suite. Until somewhat recently, commercial/multifamily finance firms tended to represent one or two investor groups. A firm was generally known as a life company lender or correspondent; a Fannie Mae Delegated Underwriting and Servicing (DUS™) or Freddie Mac Program Plus® lender; a CMBS conduit; or a bank or thrift portfolio lender. In recent years, however, many firms have branched out (or been swallowed up) in order to represent more investor groups and to offer borrowers a wider range of different products and services.

The result has been consolidation of specialized firms into larger firms with multi-product and multi-lender platforms. Consolidation has been a major force in many industries in recent years, and commercial/multifamily real estate finance is no exception.

MBA's *Annual Commercial/Multifamily Originator Rankings* show that in 2006, the top three originators accounted for more than 25 percent of the total dollar volume of commercial/multifamily originations. The top nine firms originated more than half of the total loan volume.

Many of the names that have been leaders in their product segment—names like the WMF Group, Berkshire Mortgage, LJMelody, Reilly Mortgage Corporation, Lend Lease, CRIIMI MAE Inc. or Allied Capital—are now part of large, integrated financial services firms. The acquiring companies have included names such as Charlotte, North Carolina–based Wachovia Corporation, San Francisco–based Wells Fargo & Co., Los Angeles–based CB Richard Ellis Group Inc., Frankfurt, Germany–based Deutsche Bank AG, Needham, Massachusetts–based CWCapital LLC and Newark, New Jersey–based Prudential Financial Inc.

The original companies didn't go away. Instead, they brought their people, their products and their relationships to the newly combined firms, thereby providing greater resources and range to the combined entity.

With the growth and innovation of the real estate finance markets has come a set of more complex—and more structured—financial instruments and relationships. The borrower's legal relationship is now often with a special-purpose trust rather than with a lending institution. The trust, in turn, is represented by a master servicer, which often oversees a cadre of subservicers.

To complicate matters further, the trust is responsible to a set of anonymous investors with a range of interests (from triple-A-rated to unrated); and those investors' interests are not solely in that borrower's specific loan, but rather in a

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tranche of a security backed by an entire pool of loans.

There are other forces that also play significant roles. Regulators—from the Securities and Exchange Commission (SEC) through its Regulation AB, to the Internal Revenue Service (IRS) with its real estate mortgage investment conduit (REMIC) regulations—and then quasi-regulators (such as rating agencies that rate deals and monitor servicer activities) add still more complexity to the servicer's business.

Even whole-loan servicing is more complicated—financial engineering in the form of participations and B notes have increased the complexity and number of players involved in the ongoing servicing of a loan.

The result has been an increased need for sophistication and specialization in the servicing of these mortgages.

Evolving servicing roles and responsibilities

With a changing industry has come evolution in the roles, responsibilities and relationships of commercial/multifamily servicers. Servicing volumes are increasingly concentrated among the largest servicers, even as those servicers take on a wider range of investor groups and servicing roles. At the same time, the level of sophistication required to service commercial/multifamily loans is growing exponentially.

Just five years ago, commercial/multifamily finance firms tended to specialize in servicing for one or two specific investor groups. Like their counterparts on the origination side, firms were generally known as life company correspondents, agency (DUS or Program Plus) servicers, bank-portfolio or CMBS servicers.

Today, especially among larger firms, a diversity of capital sources has become the norm. According to MBA's annual servicing surveys, among the top-10 CMBS servicers at the end of 2001, 63 percent of their servicing volume was in CMBS loans. By year-end 2006, that number had fallen to 61 percent.

Similarly, one-third (33 percent) of the servicing volume of the top-10 Fannie Mae and Freddie Mac servicers in 2001 was in Fannie Mae and Freddie Mac loans. By year-end 2006, that number had fallen to 12 percent.

And at year-end 2001, 47 percent of the servicing volume of the top-10 life company servicers was in life company loans. By year-end 2006, that number had fallen to 24 percent. Put another way, servicers today are less focused on any one investor group than they were just five years ago.

Driven by consolidation and by ever-broader origination platforms, servicing portfolios have increasingly included loans held by different investor groups. As a result, individual servicers must now be responsive to different investor groups with very different requirements and styles. These differences range from the strict terms of individual pooling and servicing agreements (PSAs) of CMBS deals, to the generalized rules in the Fannie Mae and Freddie Mac guides, to the less-rigid, relationship-driven decision-making that often comes with life company investors.

At the same time that investor-driven distinctions among servicers are fading, the roles a servicer plays are becoming clearer.

"Servicing" is now generally seen to encompass a range of responsibilities that can be divided up and parceled out to different parties. In a CMBS deal, it is common to have a primary servicer, a master servicer and a special servicer each formally designated on a deal. These distinct roles are increasingly applicable to other investor groups as well.

The primary servicer generally takes responsibility for most direct borrower interactions, including billing borrowers for their payments and the collection of property inspections and property financials. The master servicer oversees the deal's primary servicers and is responsible for approving borrower requests—including assumptions and payoffs—and for investor reporting and remittance. The special servicer is designated as the party that will step in to handle a problem loan or a foreclosure.

While some firms may concentrate on one of these roles—say, primary or special servicing—there are large books of business for which a servicer plays multiple roles (for example, acting as both the primary and master servicer for a particular set of loans).

The functions associated with each role have been around and part of servicing for decades, but the growth of the CMBS market has prompted a growing disintegration of the roles. For example, for the first time last year, MBA's annual servicing survey provided life companies and banks the opportunity to classify as "master servicing" their roles and responsibilities with regard to loans in their own portfolios.

> With a changing industry has come evolution in the roles, responsibilities and relationships of commercial/multifamily servicers.

It is important to note that not all servicing firms are pursuing the same objectives or pursuing them to the same degree. One firm may place more weight on servicing as a profit center, with key drivers being revenue retention and cost reduction. Another firm may stress the link between servicing and originations, placing a greater emphasis on customer satisfaction and retention than on cost-reduction. A third firm may place portfolio oversight and risk prevention at the top of its priority list, keeping a close eye on asset performance and the firm's ability to identify and act on any signs of weakness.

The reality is that all servicing firms are constantly balancing these and other goals, and no two firms are exactly alike in how they weigh these and other objectives they pursue.

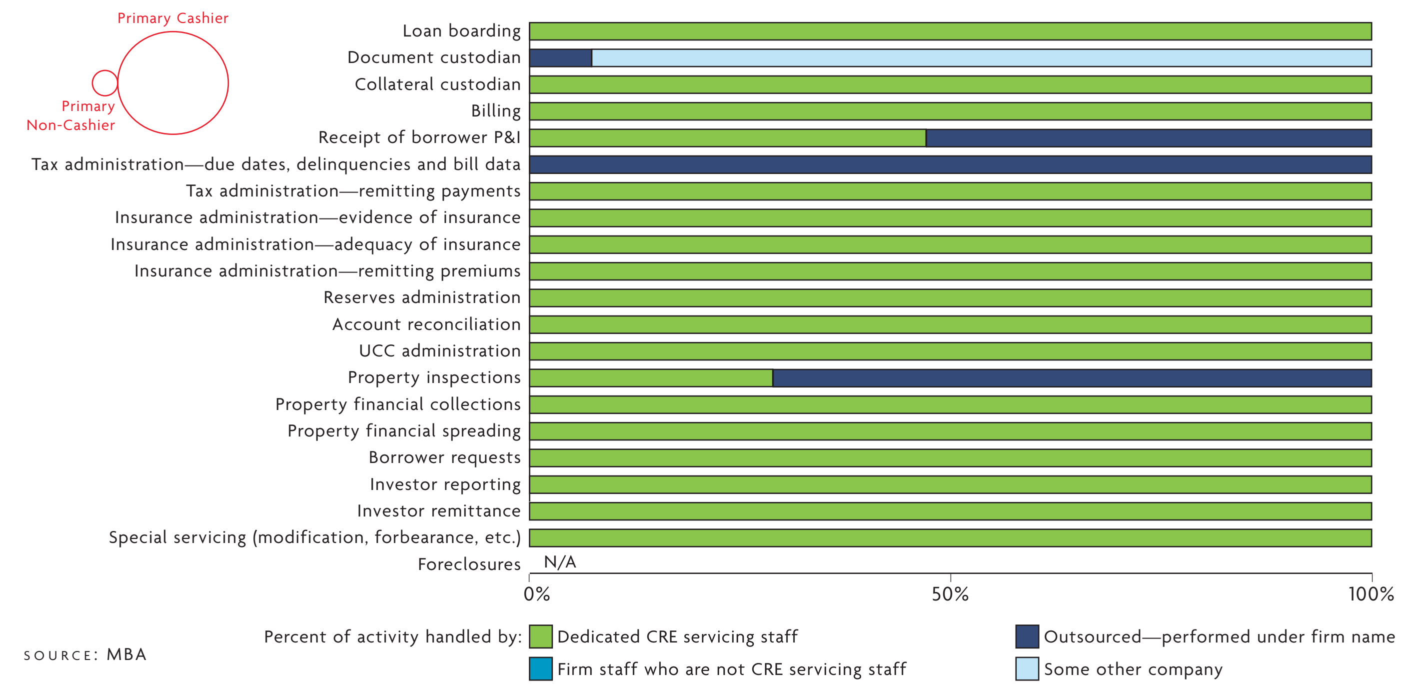
Evolving servicing models: A five-firm case study

To further explore the different roles servicing firms are playing, MBA, working with five anonymous servicing firms

Figure **1** **Company A Activity (Primary Cashier/Special)**

SOURCE: MBA

Figure **2** **Company B Activity (Primary Cashier/Primary Non-Cashier)**



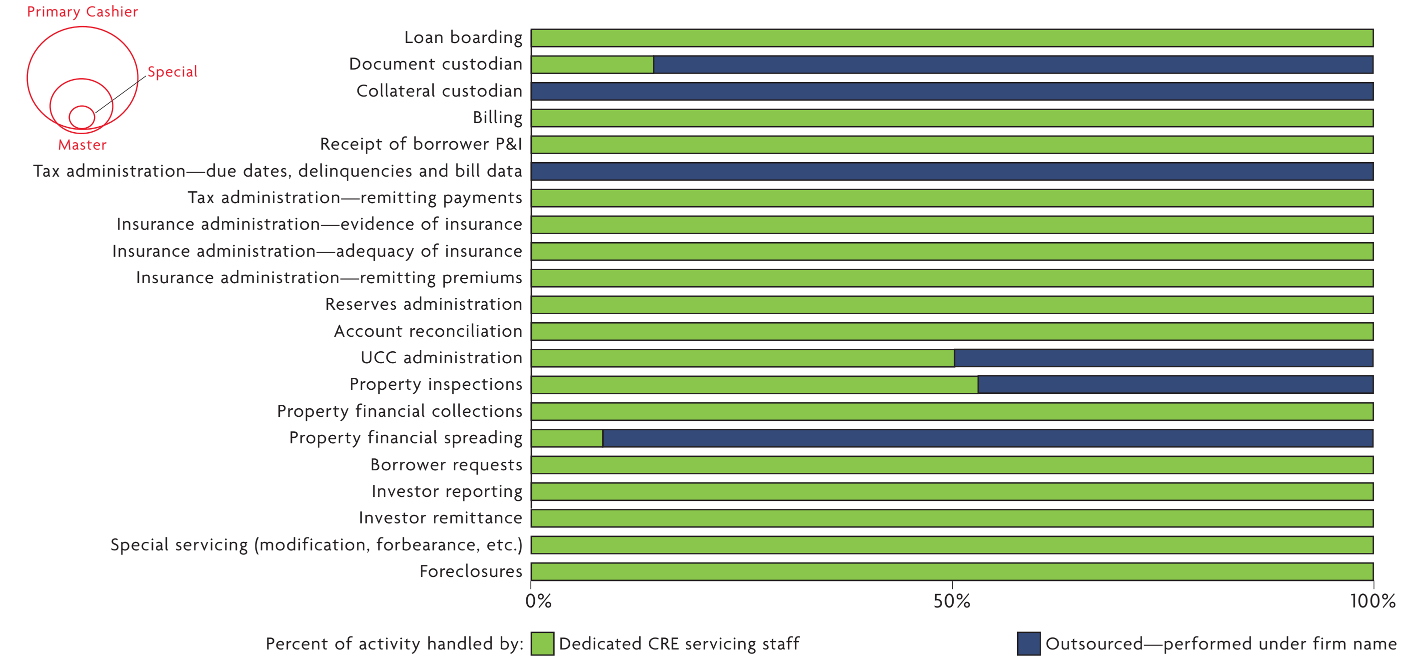
SOURCE: MBA

in advance of its 2007 Asset Administration and Technology Conference, developed a set of questions for the firms to answer. The goal was to paint a picture of how these firms managed their range of roles and responsibilities. What the study found was a significant diversity of approaches to commercial/multifamily mortgage servicing.

The firms that participated in the case studies represent a broad range of servicing models. Among them, the five firms service for nearly every investor group and fulfill a range of roles—from primary non-cashier servicing to special servicing. Like every servicing firm, each firm in the case studies has a unique portfolio mix—some with more CMBS loans, some with more Fannie Mae or Freddie Mac loans, some with more life company loans.

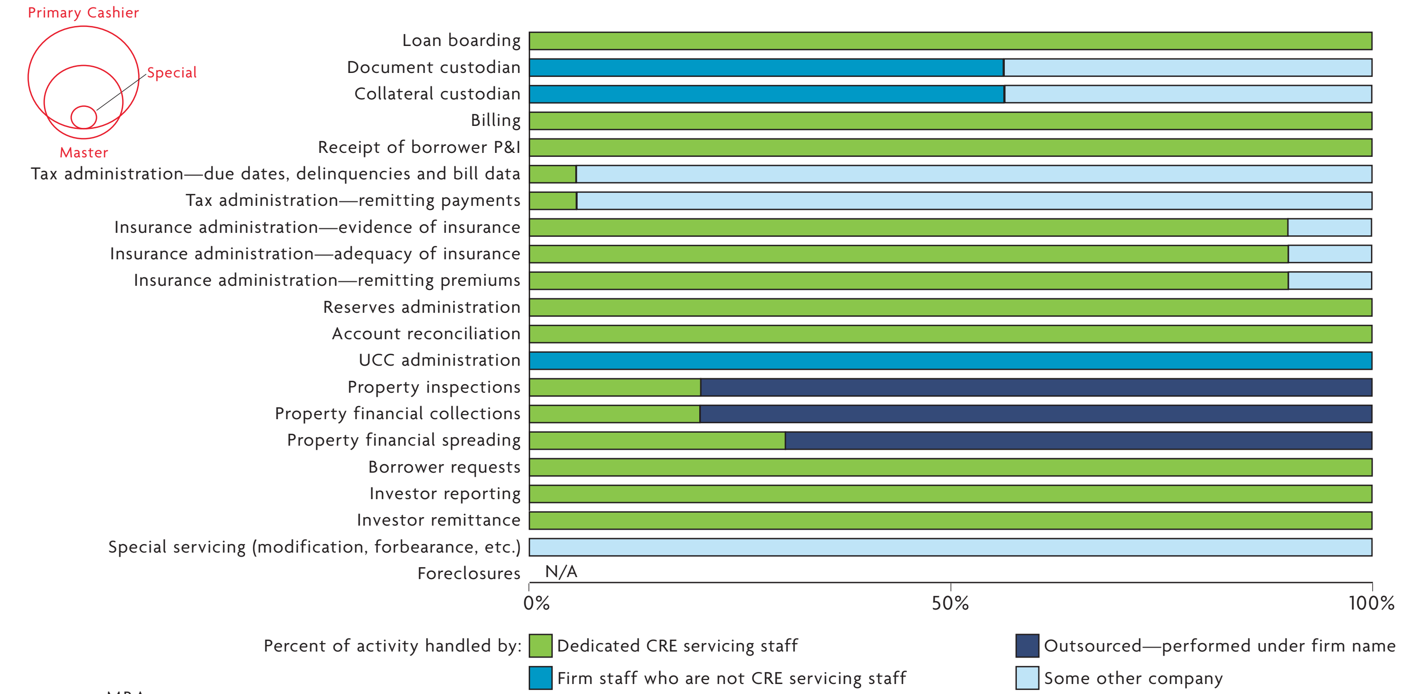
Each firm also has a unique mix of servicing responsibilities, whether special, master or primary (cashiering and

Figure 3 **Company C Activity (Primary Cashier/Special/Master)**



SOURCE: MBA

Figure 4 **Company D Activity (Primary Cashier/Special/Master)**



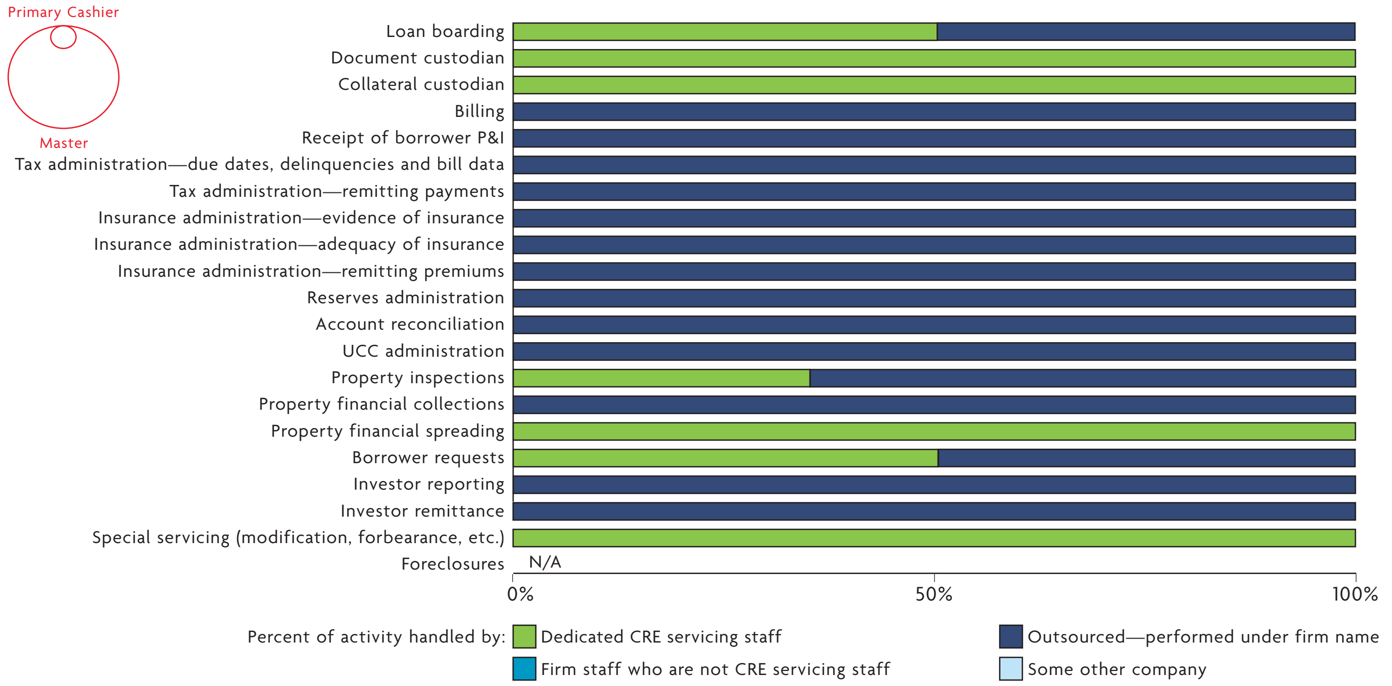
SOURCE: MBA

non-cashiering). As mentioned earlier, while these terms have generally been thought of in the context of CMBS, they are used here to describe servicing roles across investor groups, including life company, Fannie Mae, Freddie Mac, the Federal Housing Administration (FHA) and commercial bank/thrift loans.

Looking at the individual companies, Company A is predominantly a primary servicer with cashiering responsibility (see Figure 1). It also has a special servicing role/responsibility on a subset of the loans for which it is primary servicer.

Company B, by contrast, does no special servicing but does have a (relatively small) set of loans for which it has non-cashier primary servicing responsibilities (e.g., performing property inspections and collecting property financials) in

Figure 5 **Company E Activity (Primary Cashier/Master)**



Note: Firm is responsible for outsourced activities and performs oversight. Firm also steps in on exceptions.

SOURCE: MBA

addition to its more dominant role as a primary servicer with cashier responsibilities (e.g., collecting principal and interest payments) (see Figure 2).

Company C and Company D are similar in terms of their roles, in that they each primary-service a set of loans (see Figures 3 and 4). Also, they are each the master servicer for a subset of the loans they primary-service, and they each special-service a subset of the loans that they master-service. For each of these two servicing companies, there is also a set of loans that they master-service but do not primary-service or special-service.

Finally, Company E is focused mainly on master servicing—although the firm also primary services a subset of the loans it master-services (see Figure 5).

A growing range of responsibilities

Servicing increasingly can be seen as not just one, but as a whole range of disciplines. These range from billing to insurance administration to accounting to asset management to investor relations to special servicing (to name a few), and each of these carries its own specialized set of knowledge.

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Among the five firms that participated in the 2007 MBA Asset Administration and Technology Conference case studies, each was unique in its responsibilities and in its approach to performing common servicing tasks.

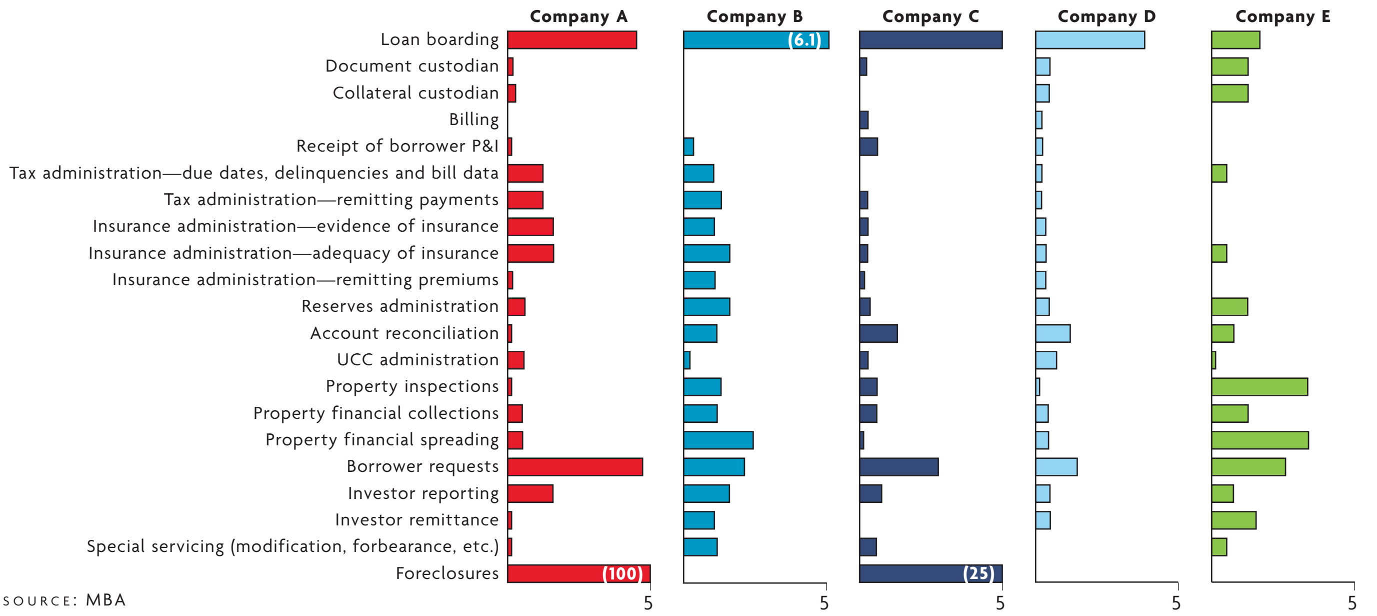
Three of the five firms (Companies A, B and C) have dedicated commercial real estate (CRE) servicing staff who perform the lion's share of their servicing functions. However, each of these firms also outsources at least some functions.

Company A outsources all of its property inspections. Company B outsources the majority of its inspections as well as portions of its tax administration, receipt of borrower principal and interest (P&I) payments, and document-custodian responsibilities. Company C outsources all or part of its work in document custodianship, collateral custodianship, tax administration, Uniform Commercial Code (UCC) administration, property inspections and property financials.

But the bulk of servicing tasks for each of these three servicing portfolios is performed by staff from each of the firms' servicing groups.

A fourth firm (Company D) also outsources certain functions, including property inspections and the collection and spreading of property financials. Company D also relies on other staff within the firm (but outside of the CRE servicing

Figure **6** **Task-Specific Full-Time Equivalents (FTEs) per 1,000 Loans**



SOURCE: MBA

group) to perform certain functions, including document custodianship, collateral custodianship and UCC administration. Company D has merged certain CRE servicing functions with similar functions from other business lines as a way of gaining efficiencies, controls and/or other benefits.

With greater master-servicing responsibilities than Companies A, B or C, Company D also has relatively few responsibilities for certain primary servicing functions. As a result, a greater share of Company D's loan functions is performed by some other party, without the firm itself needing to perform or outsource the function. In general, Company D is required to do less custodianship, tax administration and insurance administration than are Companies A, B and C.

The fifth firm, Company E, adds important color to the diversity of servicing models. Coming from the perspective of a master servicer—with more responsibility for the overall performance of the loans and less borrower-facing servicing activity—Company E has outsourced the bulk of the tasks associated with servicing. Company E has retained in-house the activities related to certain functions, including managing loan collateral, performing certain property inspections, spreading borrower financials and processing borrower requests.

An important factor in the decision to outsource activities, as done by Company E, is the fact that out-of-sight does not mean out-of-mind. Company E still carries the responsibility (and often staff) to make sure the functions are performed correctly. In addition, because of the many parties involved and the importance of the relationships, Company E must stand at the ready to step in at the first signs of any friction among its outsourced service providers and any other business partners/clients.

Staffing issues

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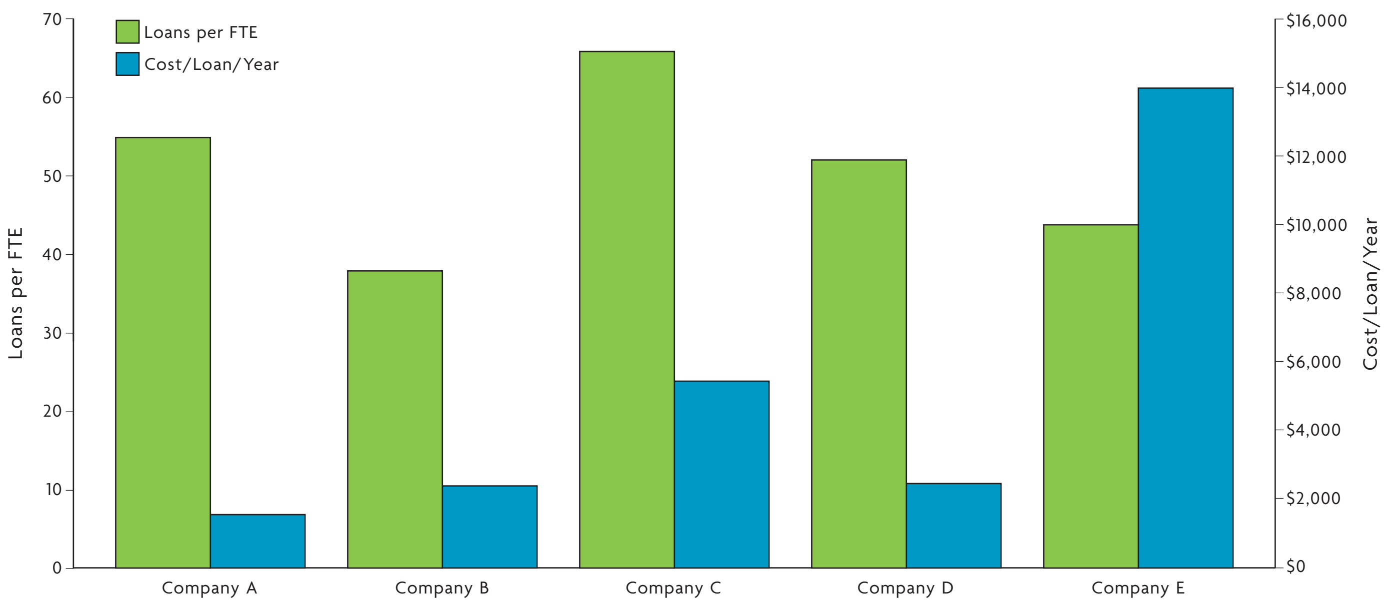
Among all firms studied, certain tasks jump out as very labor-intensive, regardless of how a firm chooses to accomplish them. These include loan boarding, processing borrower requests and—when they occur—foreclosures. A small number of tasks, most notably billing, appear to be fairly light users of CRE servicing staff. In general, however, different firms face very different levels of staffing for any given function.

Expressed as the number of task-specific full-time equivalents (FTEs) per 1,000 loans serviced, for most tasks a given firm may use twice the number of FTEs per loan as another firm (see Figure 6).

Company B, for example, uses many more FTEs per loan for financial spreading than does Company A, while Company A uses many more FTEs per loan on borrower requests.

A key reason for this disparity is the large number of factors affecting staffing demand. When one layers a servicing firm's unique mix of investor groups with its distinct servicing roles

Figure 7 **Loans per Dedicated In-House Servicing FTE and Ballpark* Average Cost/Loan/Year**



*Ballpark estimates that are not standardized across servicers. One servicer may include costs and activities that others do not, and different servicers may characterize expenses differently.

SOURCE: MBA

and its decisions about which functions to perform in-house versus outsource, then adds in the size of the servicing shop, potential synergies with a corporate parent and other factors, the range of potential staffing options becomes nearly limitless.

That being said, among the case-study firms, the total number of loans serviced per dedicated servicing staff FTE fell in a relatively narrow band—ranging from 38 FTEs for Company B to 44 for Company E to 52 for Company D, 55 for Company A and 66 for Company C (see Figure 7).

Servicing costs per loan

Given the various responsibilities and approaches taken by the case-study firms, it is not surprising that there is great diversity in the range of estimated ballpark servicing costs per loan per year (see Figure 7). It's important to note that these figures are estimates, and that any given servicer is likely to include costs that another does not.

But as would be expected, the evolution of different servicing approaches has led to the different costs—ranging from a ballpark cost estimate of about $1,600 to service a loan for Company A, to $2,500 for Company B and about $2,500 for Company D, to about $5,500 for Company C and $14,000 for Company E.

These figures are ballpark estimates and subject to considerable variance in how they are estimated. But they show the wide variety in servicing costs that come as firms play different roles, perform different tasks, oversee different loan sizes for different investor groups and pursue different business objectives though the servicing function.

> A firm must clearly define its objectives in order to determine the most appropriate measures of efficiency or success.

Closing note

The goal of this effort was to try to better understand how commercial/multifamily servicing firms are addressing the increasing sophistication and specialization of the real estate finance industry. The results show five representative firms each following a unique path, based on each firm's own mix of roles, investors, organizational structure and objectives.

Perhaps most important, however, is the fact that a firm must clearly define its objectives in order to determine the most appropriate measures of efficiency or success. Only then will it be able to find measurements to help it better understand the degree to which its choices about outsourcing, staffing and/or choosing to serve various product lines and investors are (or are not) helping to accomplish those goals. **MB**

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