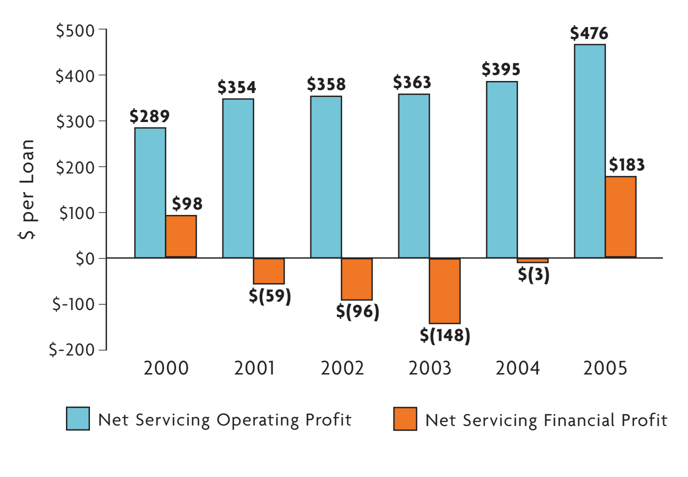
Servicing Study Shows Strong 2005 Results

Servicers returned to financial profitability in 2005 for the first time since 2000, according to a comprehensive annual servicing study prepared by the Mortgage Bankers Association. Once known as the *Cost of Servicing Study*, the new name is *The 2006 Servicing Operations Study and Forum* for prime and nonprime servicers.

BY MARINA WALSH

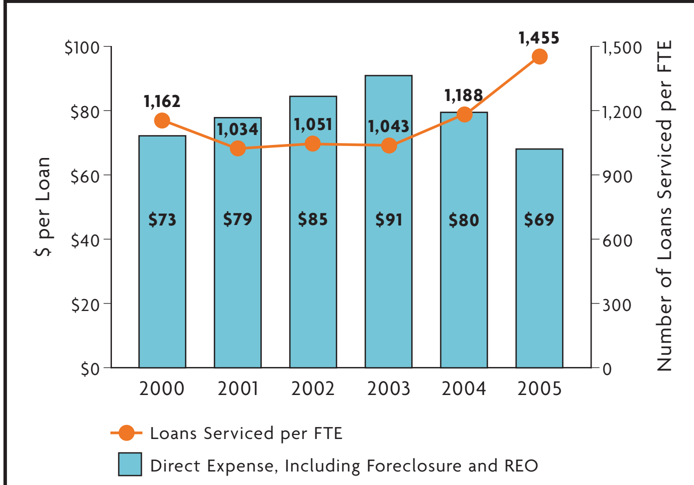
For prime mortgage servicers, 2005 was a year filled with new records. Net financial income and net operating income were at new study highs during 2005, according to findings collected since the inception of the *Cost of Servicing Study (COSS)* in 1999. To top it off, direct expense per loan was at its lowest level, and productivity skyrocketed to new heights. ▯ The key drivers of this success were lower portfolio churn, low default rates and larger average portfolios that drove down costs for processing-intensive servicing functions. This was all welcome news for servicers. ▯ But servicers were not simply resting on their laurels in 2005. Instead, they were hunkering down and contemplating ways to increase revenues and mitigate costs even further. With net production margins down from industry highs, the role of

Figure **1** **Prime Servicing Net Profits at New Study Highs in 2005**



SOURCE: MBA's 2006 SERVICING OPERATIONS STUDY AND FORUM

Figure **2** **Prime Direct Expense and Productivity Study Records in 2005**



SOURCE: MBA's 2006 SERVICING OPERATIONS STUDY AND FORUM

the servicer in contributing to the bottom line became all the more crucial. Among the major challenges:

- How to service the myriad new products and expanded servicing volume in the most efficient and profitable way possible?
- With the merging of prime, alternative-A and subprime businesses, how to understand the discrete costs of servicing these very different product lines?
- How to pinpoint the operational drivers that most affect cost?
- How to mitigate costs when portfolios begin to age, delinquencies rise or adjustable-rate mortgages (ARMs) reset?

With this business environment and these challenges in mind, the Mortgage Bankers Association (MBA) embarked on its eighth annual servicing benchmarking study. This year the study had 40 participants, including most of the top-10 residential servicers.

Some changes to the study

Among the study changes in 2006, we have a new name: *The 2006 Servicing Operations Study and Forum for Prime and Subprime Servicers (SOSF),* formerly known as the *Cost of Servicing Study.* The change better reflects the program's contents and its participants.

Over the years, the program has moved beyond cost metrics to detailed information on servicing operations, best practices and internal reporting, as well as the opportunity for face-to-face contact with peers through an annual roundtable. Additionally, we expanded our subprime servicing peer group, which was included in the study for the first time last year. This year we doubled the number of participating subprime companies, which together comprised approximately 3.6 million loans serviced.

A third change introduced with the 2006 study was to roll out an experimental "hybrid servicer" subset group. While all companies in the study were delineated as either prime or subprime for our main peer groupings, this particular subset included companies whose product mix and/or direct cost did not quite fit with its major peer group.

For example, the hybrid subset included servicers with a heavier alt-A portfolio share or a mix of both nonprime and prime loans. As a result, average hybrid direct expenses in 2005 were higher than the prime average, but lower than the subprime average.

Ultimately, the goal of these changes was to better understand the operational practices that most influence the servicing operations' bottom line and get a better handle on costs by product mix. Now let's analyze the results.

Six-year historical trends—prime sample

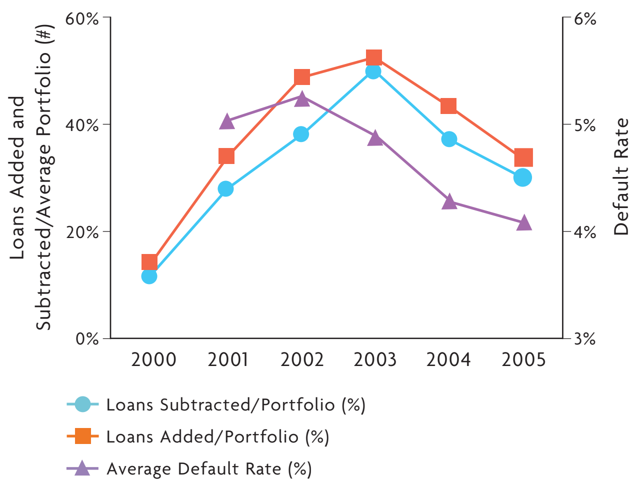
Net servicing operating and financial profits

Figure 1 displays the six-year trend analysis of net servicing operating and financial profit. Net operating profit (which excludes amortization of servicing rights, impairments, hedging gains or losses, and bulk servicing sales) rose by 21 percent, reaching a study high of $476 per loan in 2005. The major contributors to this increase:

- Driven by average loan balances that rose 10 percent in 2005, per-loan servicing fees continued to escalate, reaching $472 per loan in 2005;
- Net escrow earnings from custodial accounts rose by 39 percent to $115 per loan in 2005;
- Record-low weighted average servicing direct expenses dipped 14 percent to $69 per loan, while productivity increased by 23 percent to 1,455 loans serviced per employee (see Figure 2); and
- Indirect costs—corporate allocations, interest expense on servicing assets, bank charges and mortgage-backed security (MBS) interest expense—also declined by 8 percent to $93 per loan in 2005.

Just as servicing operating profits swelled, so did servicing financial profits rebound in a big way from the dismal 2001–2003 levels. Taking into account mortgage servicing rights (MSR) amortization, impairments, hedge gains and losses, and bulk servicing sales, net servicing financial profit rose to $183 per loan in 2005—the first time that prime servicers

Figure **3** **Prime Churn Factors and Default Rate in 2005**



SOURCE: MBA'S 2006 SERVICING OPERATIONS STUDY AND FORUM

have posted positive net earnings since 2000 (see Figure 1).

Instead of MSR impairment—the standard for the last four years—servicers reported gains in servicing rights valuations that added about $100 per loan to the financial bottom line. Offsetting losses from MSR hedging programs were surprisingly minimal, averaging just a $2 loss per loan. The servicing business appeared to retain its status as a natural hedge to the production business after all.

Factors driving net operating profit and productivity

What factors contributed to the favorable servicing environment in 2005? First, servicing setups and payoffs in relation to average number of loans serviced continued to drop for the second consecutive year (see Figure 3).

Not only did this reduction in churn ease the financial and operating burden on servicing shops, but it also helped to drive up servicing net escrow earnings. True—ancillary fees steadied at about $50 per loan serviced in 2005 with fewer charges for statements, payoff quotes and other borrower-requested items related to payoff. But in general, reduction in payoff churn benefited mortgage servicers.

Coinciding with the drop in churn were low default rates, an "as good as it gets" scenario. The average default rate (incorporating average delinquencies, foreclosures and real estate–owned [REO]) was the lowest recorded yet for the *SOSF* at 4.08 percent. These low default rates kept direct default expenses and unreimbursed foreclosure and REO losses in check.

Other factors drove average net operating profit. Some small to medium-sized prime servicers exited the business (and our study). Those smaller servicers that stuck around generally had lower costs or provided niche servicing to stay competitive. Among this peer group, for example, the average servicing costs dropped precipitously to $90 per loan in 2005 from $145 per loan in 2004.

As for the megaservicers, they continued to drive up per-loan servicing fees and net escrow earnings with higher-than-ever loan balances, while reducing costs through technology advances, outsourcing, offshoring and leveraging bank/affiliate resources.

Study results by prime, hybrid and subprime in 2005

New SOSF *peer groups and performance overview*

While the summary historicals here represent our traditional prime participant base, the exponential growth in subprime and alt-A servicing warranted expanding our study coverage to other types of servicers. Figure 4 presents the *SOSF* major peer groups and their respective servicing portfolio profiles. Note: All data presented herein are simple averages, which best represent the individual peer groups because each servicer receives equal weighting. Keep in mind that the hybrid group is a subset of companies already included in one of the other four peer groups.

Generally, average FICO® scores and loan age dropped when moving along this rudimentary credit spectrum from prime to hybrid to subprime. Similarly, default rates and

Figure **4** **2005 Peer Groups and Portfolio Profiles**

	Prime Small/Medium	Prime Large	Prime Mega	Hybrid Subset	Subprime
Average Number of Loans Serviced	34,601	383,551	2,974,571	268,927	259,649
Average Loan Balance	119,381	145,249	143,979	160,078	138,492
Portfolio Characteristics:					
Average FICO®	697	714	715	698	640
Average Default Rate	3.18%	4.26%	4.03%	5.70%	12.76%
% ARM/HELOC/IO	20%	34%	17%	55%	48%
Average Loan Age:					
% Less than 24 Months	34%	55%	40%	67%	83%
% Greater than 24 months	66%	45%	60%	33%	15%
Churn:					
Loans/Added Portfolio (%)	32%	44%	25%	65%	77%
Loans Subtracted/Portfolio (%)	29%	37%	21%	54%	52%

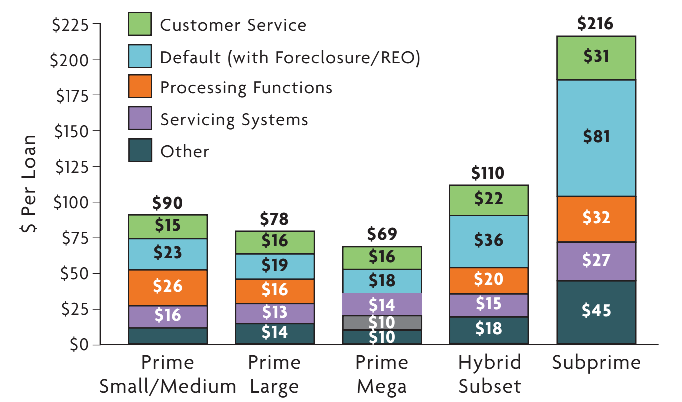
SOURCE: MBA'S 2006 SERVICING OPERATIONS STUDY AND FORUM

Figure 5 2005 Servicing Performance at a Glance, $ per Loan (Simple Averages)

	Prime Small/Medium	Prime Large	Prime Mega	Hybrid Subset	Subprime
Direct Servicing Revenues	$375	$455	$519	$516	$725
Direct Expense (with Foreclosure/REO)	$90	$78	$69	$110	$216
Corporate Allocation	$24	$18	$17	$26	$45
Fully Loaded Expense	$114	$96	$86	$137	$261
Net Interest Income	$12	$34	$41	$47	$15
Net Operating Income	$272	$392	$474	$426	$480
Loans Serviced per FTE	931	1,461	1,589	960	479

SOURCE: MBA'S 2006 SERVICING OPERATIONS STUDY AND FORUM

Figure 6 2005 Direct Servicing Expense by Function



SOURCE: MBA'S 2006 SERVICING OPERATIONS STUDY AND FORUM

servicing churn increased as you move from prime to hybrid to subprime peer groups. Loan setup volume also grew on this continuum, demonstrating the proliferation of subprime and hybrid product.

A telling study statistic: The ratio of average setups to average servicing portfolio for hybrid and subprime servicers was close to triple that of prime megaservicers in 2005.

These major peer group portfolio characteristics provide a backdrop for understanding the key revenues, expense and productivity benchmarks displayed in Figure 5. It's no surprise that per-loan direct servicing revenues were highest for subprime servicers at $725 per loan. On the flip side, subprime servicers' fully loaded expenses were about three times higher than the larger prime servicers and two times larger than the small prime and hybrid servicers.

In addition, the average number of loans serviced per full-time equivalent (FTE) was just 479 for the subprime servicers, three times lower than the larger prime players and about half that of the small prime and hybrid servicers.

The operational bottom line in 2005 shows the megaservicers, hybrids and subprime players in the range of $426 to $480 in net operating income, while the smaller players trailed. At least in 2005, two approaches to optimal returns appeared to be servicing portfolio growth and/or specialty product servicing.

Servicing revenues

Taking a closer look at servicing revenues, net servicing fees for subprime servicers averaged $619 per loan, or about 45 basis points. Most of the prime and hybrid servicers' net servicing fees were in the range of 30 basis points, but diverged on a per-loan basis due to differences in average loan balances.

For servicers that held their loans in portfolio (no third-party investor) or that serviced loans for an affiliate or parent, *SOSF* definitions had standard guidance for estimating service fees. Nonetheless, it was more difficult for portfolio servicers to provide accurate service fees for benchmarking purposes. For this reason, the *SOSF* gathered information on different internal reporting practices such as whether servicers with portfolio loans were reimbursed at cost, subservicing rates or market rates.

Other sources of revenues included late fees and other ancillary fees. Subprime servicers earned more late fees and ancillary income than the other groups. With higher delinquencies, it was not surprising to see subprime late fees per loan at about three times those of the prime peer groups.

Subprime servicers also garnered the highest average ancillary fees (excluding prepay income). The major ancillary fees setting them apart from the rest were "quick payment" services (such as phone or Web payments), and fees for customer requests relating to payoffs.

One area of operational focus for servicers of all shapes and sizes was collections efforts for both late fees and ancillary fees, as well as determining best practices for late-fee waivers. *SOSF* results indicate that there were no billings for 36 percent of late fees and 38 percent of ancillary fees in 2005.

Some servicers indicated that it was hard to justify active payment pursuit given the incremental revenue; they could always "settle up" at payoff. Other servicers simply relied on borrowers to be prompted by the "late fee" line on coupon books. Still, with increasing pressure to maximize revenues in a downward production market, several servicers reported that current practices were under reconsideration.

A final source of revenue for servicers was escrow earnings generated through tax and insurance custodial accounts as well as principal and interest custodial accounts. Across the board, almost all servicers posted gains in escrow earnings over 2004 as the result of increases in short-term interest rates and higher custodial balances due to increased property values. But the megaservicers and hybrid servicers did especially well, with higher average loan balances translating into increased escrow earnings.

Figure **7**	**2005 Customer Service Details**				
	Small/Medium	**Large**	**Mega**	**Hybrid Subset**	**Subprime**
Expense:					
Direct Expenses ($ per Loan)	$14.86	$16.03	$16.24	$21.59	$30.92
Direct Expense ($ per Inquiry)	$7.70	$5.27	$4.89	$6.09	$5.55
Workload:					
Customer Inquiries per Loan	2.9	3.5	4.2	4.0	6.2
% Inquiries Handled via IVR	15%	44%	41%	44%	44%
% Companies Conducting Outgoing Calls	29%	56%	25%	38%	33%
Companies with Outsourcing	14%	44%	50%	33%	31%
Billing Communications:					
Monthly Billing Statement	36%	66%	47%	80%	87%
Coupons	52%	26%	33%	10%	8%
Other	12%	8%	21%	11%	5%
Total	100%	100%	100%	100%	100%

SOURCE: MBA'S 2006 SERVICING OPERATIONS STUDY AND FORUM

Servicing expenses

Turning to servicing cost—the fundamental basis for the *SOSF* —there were 30 types of costs in this year's study, including, among others: salaries; service bureau fees; systems expense and depreciation; bonuses and benefits; mail; supplies; telephone service; occupancy; equipment and outsourcing. Servicing costs were also divided into cost centers, or functions (such as customer service).

Most peer groups divided direct servicing cost into 17 functions; the small/medium prime servicer group divided cost into eight functions. In the interest of space (or as enticement to participate in the study next year and receive full results), Figure 6 displays total direct servicing expenses grouped into five major functions: customer service, default, processing-focused functions, servicing systems and servicing administration/other specialized functions. Customer service included the costs associated with customer-driven inquiries and most non-default external communications with borrowers, whether it was welcome calls or billing statements.

Another differentiating feature for the smaller prime servicers was that only 15 percent of these inquiries were handled through interactive voice response (IVR).

In per-loan terms, there appears to be a more even playing field among the three prime peer groups in 2005 (see Figure 7); the cost differential among these groups was less than $2 per loan. The smaller prime servicers benefited from fewer customer inquiries, so that even though their cost per inquiry was the highest of any peer group, costs per loan were contained. Customer inquiries may include call center, written correspondence, e-mail and other electronic inquiries, such as self-serve Web inquiries.

Another differentiating feature for the smaller prime servicers was that only 15 percent of these inquiries were handled through interactive voice response (IVR). All other groups were more than 40 percent in IVR handling—even the subprime servicers (see Figure 7). This result begs the question of general effectiveness of IVR systems. For many servicers with automated response at their call centers, there is constant menu adjustment and readjustment to best meet the needs of customers while remaining cost-effective.

Some servicers were encouraging customers to bypass call centers completely and use the Internet to access the information they need through a "self-serve" process. According to *SOSF* results, an average of 35 percent of customers had an online account to access information. Still, more than 80 percent of inquiries were handled through call centers.

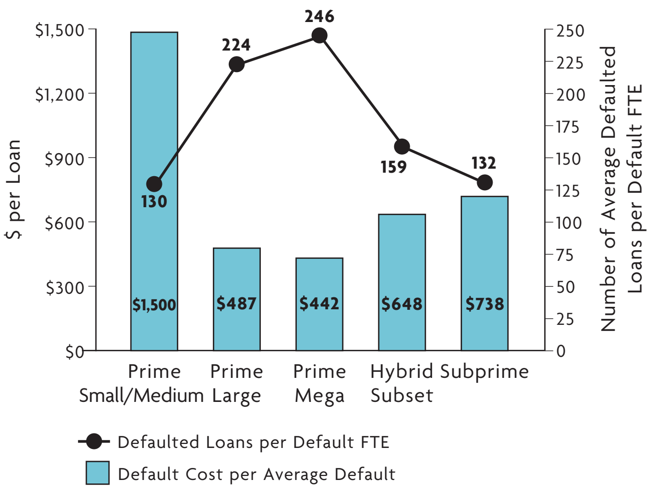
Figure 7 also sheds light on how each peer group handled billing in 2005—another factor that can affect customer-service costs. While the smaller servicers mostly relied on coupons for billing purposes, the subprime servicers and hybrid servicers were heavily reliant on monthly statements, because of the nature of the loans originated. Servicers with a portfolio mix that includes ARMs, home-equity lines of credit (HELOCs), interest-only loans and pay-option plans relied on the monthly statement to keep borrowers informed about payment and/or rate changes.

As an acknowledgment that "one size may not fit all," the megaservicers appeared to have developed different billing communications strategies for different types of borrowers and loans. For example, some borrowers who automatically remitted payments via automated clearinghouse (ACH) (checking/savings account) only received legally required statements.

A third factor influencing customer-service cost was the level of outsourcing and/or offshoring. For about 15 different servicing tasks, the *SOSF* gathered data on which servicing tasks were 1) outsourced (entirely, partly or not at all); 2) offshored (either through a captive arrangement or an outsource arrangement); and 3) handled through a joint-venture (JV) or affiliate arrangement.

In the case of customer service, the megaservicers were most likely to outsource and/or offshore customer-service

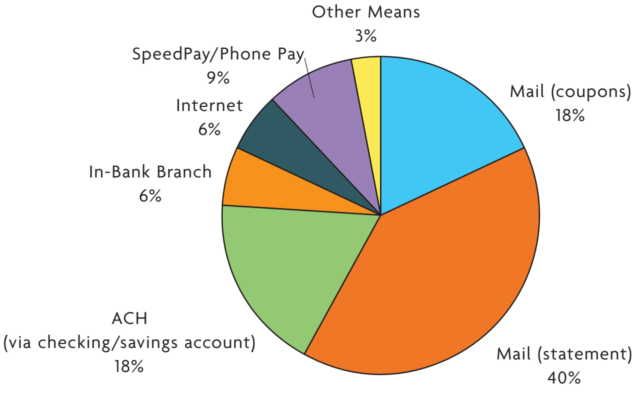
Figure **8** 2005 Default Details



NOTE: Default cost includes the direct costs (compensation, occupancy and equipment, other expenses) for servicing duties related to collections, loss mitigation, foreclosure, bankruptcy and REO, as well as unreimbursed foreclosure and REO costs due to servicer error or servicing arrangements for certain loan types.

SOURCE: MBA's 2006 Servicing Operations Study and Forum

Figure **9** 2005 Borrower Payments Remitted Via:



SOURCE: MBA's 2006 Servicing Operations Study and Forum

operations. The study found challenges in proceeding in this direction included finding the most stable locations, ensuring customer satisfaction, controlling turnover, assuring rating agencies, implementing necessary technology and managing legal arrangements.

In the area of default cost, all servicers benefited from low default rates for the respective portfolio mix in 2005. But they were cognizant that several factors could turn the tide and cause such costs to rise. These factors include the aging of portfolios, a rising interest-rate environment, re-sets of adjustable-rate loans and a slowing in housing appreciation.

Figure 8 highlights what servicers spent in servicing a defaulted loan in 2005. Default cost includes the direct costs (compensation, occupancy and equipment, other expenses) for servicing duties related to collections, loss mitigation, foreclosure, bankruptcy and REO, as well as unreimbursed foreclosure and REO costs due to servicer error or servicing arrangements for certain loan types.

Setting aside results for the small servicer group (whose default rate and default volume was the lowest, thus driving up cost), the cost of servicing a defaulted loan rose when moving from prime to hybrid to subprime portfolios. Productivity also dropped along this continuum.

Processing-focused functions (escrow administration, cashiering, investor reporting and post-payoff processing combined) represented a third major category of expense for servicers. For these particular functions, the larger servicers had the advantage in terms of cost, productivity and management to non-management ratios. Particularly for tax- and insurance-related functions, these larger servicers benefited from JV/affiliate "outsource" arrangements to best leverage resources.

In cashiering, megaservicers also benefited from having the highest percentage of ACH and other electronic remittances that drove down lockbox charges (see Figure 9 for the remittance breakdown of the entire study sample as a whole).

On the other hand, subprime servicers—many of whom saw a doubling or more in the size of their servicing portfolios over the last few years as well as high payoff churn—were experiencing growing pains, according to the 2005 operating-year findings. Several subprime servicers indicated a desire to replicate efficiencies enjoyed by the larger prime servicers.

Another crucial component of servicing expenses are servicing systems costs and other technology-related details

Figure **10** 2005 Servicing System Details

	Prime Small/Medium	Prime Large	Prime Mega	Hybrid Subset	Subprime
Expense ($ per Loan):					
Servicing Systems Expense	16	13	10	15	27
Corporate Allocation: Tech Support	3	8	6	12	14
Total	19	20	13	20	37
Workload:					
Average Number of Vendors/Systems Used	1.0	2.3	2.1	2.3	1.7
% Companies with Own System Only	29%	22%	25%	0%	23%
% Companies with Service Bureau/Combo	71%	78%	75%	100%	77%

SOURCE: MBA's 2006 Servicing Operations Study and Forum (see Figure 10). Of particular note is the dependence of the industry on service bureaus to provide the necessary technology to operate in the servicing business.

Also noteworthy is the average number of servicing systems per company; at this point, there is still the challenge of integrating all loans onto one comprehensive system. Finally, not only are there direct costs associated with using a service bureau and/or maintaining a servicing system, but there are indirect technology support costs (usually in the form of corporate allocations for general network support, help desk and the like) that should be considered. For this reason, a "fully loaded" technology cost may be more relevant for servicing managers.

Servicing administration and other specialized functions comprised the remainder of direct servicing cost. For subprime servicers, this area accounted for 20 percent of total direct cost. Based on subprime servicer feedback, the major drivers arose from new loan setups (which often did not feed directly from originations systems), the proliferation of new products, and regulatory and compliance issues.

At $16 loan setup cost per new loan added, subprime servicers' loan setup costs were almost triple those of the other peer groups in 2005. Subprime servicers also spent more on record-keeping, which encompasses imaging, document safekeeping and document custodian retrieval charges.

In 2005, servicers of all sizes were busy transitioning from the back office to being a critical source of profit.

Conclusion

In 2005, servicers of all sizes were busy transitioning from the back office to being a critical source of profit. The major challenge for the smaller prime servicers was maximizing profit and achieving efficiencies to justify "staying in the game" rather than selling their servicing rights in a favorable market.

The challenge for larger servicers was to compensate for significant declines in net production income to meet overall company financial goals.

For hybrid servicers, 2005 perhaps meant competing with larger servicers through niche-product servicing—which carried new risks, but not the same level of risk as the subprime servicing business. For subprime servicers, 2005 was an opportunity to get a handle on an expanded portfolio while default rates were still at bay.

We will need to wait until next year's results to see whether 2005 was indeed "as good as it gets" for mortgage servicing operations. Stay tuned. **MB**

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