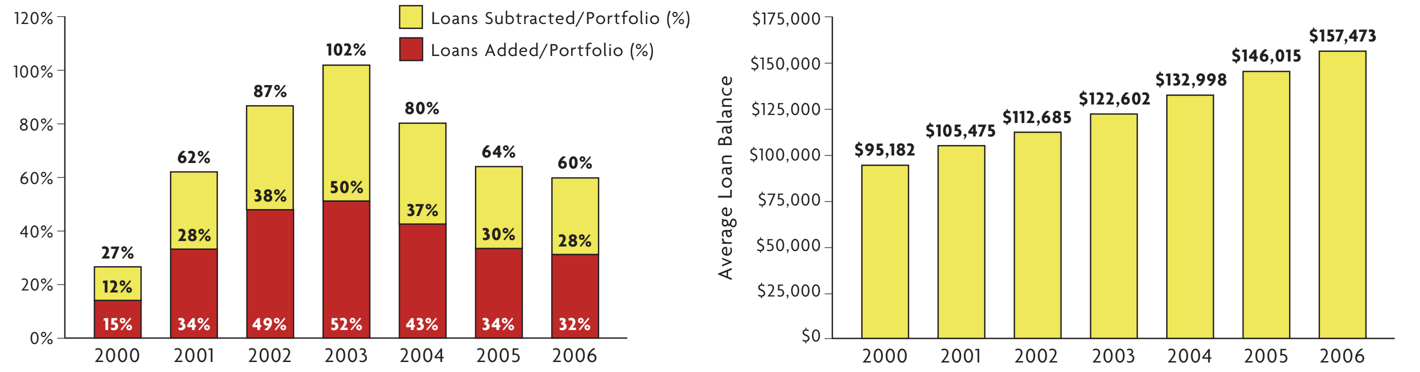
THE 2007 SERVICING OPERATIONS STUDY

The latest *Servicing Operations Study and Forum* from the Mortgage Bankers Association shows direct costs for megaservicers in 2006 actually declined to $55 per loan. Small/medium and large servicers saw their direct servicing costs rise, however.

BY MARINA WALSH

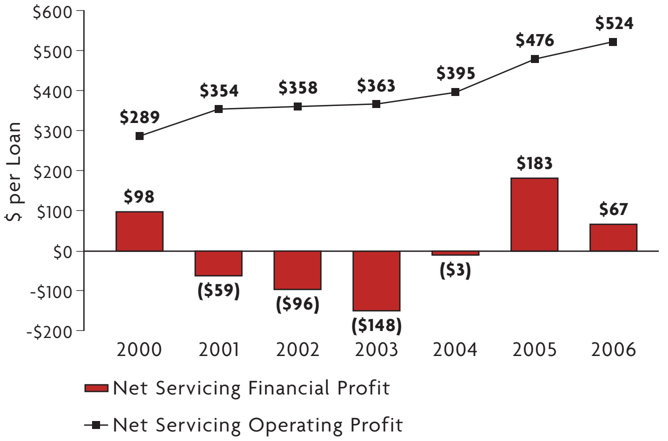
The results of the Mortgage Bankers Association's (MBA's) *2007 Servicing Operations Study and Forum for Prime and Subprime Servicers (SOSF)* may seem a bit passé given the more recent events of 2007. After all, the benchmarking study covers data through 2006—and the findings, though mixed, are not all doom and gloom. Perhaps servicers only began to grapple with the operational and financial ramifications of higher default activity in 2006; it really was not until the second half of 2006 that these issues began to hit home. And from that point until the present, the extent of this problem is still being hotly debated. Some of the questions being raised include: Are servicing costs on the rise for all servicers or just subprime or special servicers? Can we expect alternative-A servicers to feel the heat? To what extent, if any, will servicing costs rise in 2007 and 2008?

Figure 1 **2006 Prime Portfolio Trends**



SOURCE: MBA'S *2007 SERVICING OPERATIONS STUDY AND FORUM*

Figure 2 **Prime Servicing Net Financial and Net Operating Profits**



SOURCE: MBA'S *2007 SERVICING OPERATIONS STUDY AND FORUM*

For better or worse, the results presented here are based on the 2006 mortgage servicing operating environment, which may seem a product of yesteryear given the extraordinary events thus far in 2007. In 2006, we indeed saw a mixed picture. Key findings include the following:

■ Last year was a good year for prime and subprime servicers in terms of net servicing operating profits. For the prime *SOSF* sample, net operating profits set another study record—primarily due to increased per-loan servicing fees resulting from higher loan balances.

■ Despite healthy operating profits, net servicing financial profit for prime servicers dropped by more than half, due to losses attributed to mortgage servicing right (MSR) hedging programs.

■ Among megaservicers (those prime servicers with servicing volume of at least 600,000 loans), 2006 marked the fourth consecutive year of declining direct costs per loan and the third consecutive year of rising productivity as measured by loans serviced per servicing employee.

■ Among other peer groups—small/medium servicers (prime servicers with volume less than 100,000 loans), large servicers (prime servicers with volume between 100,000 and 600,000 loans) and subprime servicers—changes in the participant mix and portfolio composition meant that direct servicing costs increased and productivity decreased in 2006.

About the study, peer groups and forums

In its eighth year of publication, MBA's *SOSF* provides servicing managers with detailed information on costs, productivity and overall profitability. Though net financial profits are presented, the *SOSF* is meant to be operational in nature—focusing on costs, cost drivers and portfolio composition coupled with servicing operational practices.

The 42 servicers that participated in the *SOSF* in 2007 were organized into peer groups based on a) whether they were prime or subprime and b) the number of loans serviced. To better understand the factors driving cost and performance, *SOSF* outputs were also arranged into four additional peer grouping categories: percentage of adjustable-rate mortgage (ARM) share serviced; default rate; simple average FICO® score; and high vs. low direct servicing cost.

An integral part of the benchmarking effort is participant discussion through operations forums held in June each year. For the first time in 2007, separate operations forums were held for prime servicers and subprime servicers.

The forums allowed servicers to review data compilation to better understand company findings vs. peers, discuss most current challenges and potential solutions, and network with peers for current and future advice. Some key discussion points from the forums are included in this article. But first, the data . . .

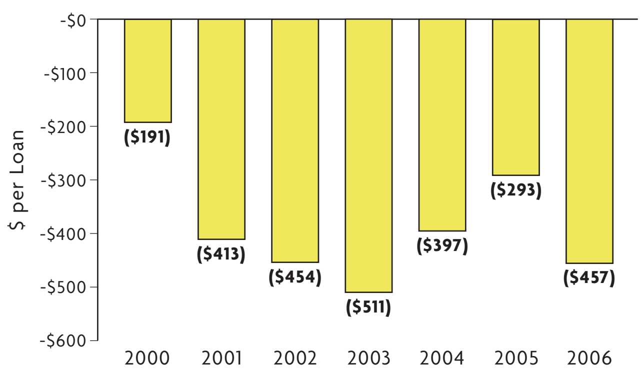
Historical trends—prime servicers

Our seven-year historical data are based on weighted averages for the full prime servicer sample. Many aspects of the mortgage operating environment were favorable in 2006. As seen in Figure 1, churn activity (measured by the number of setups, acquisitions, payoffs and transfers out divided by the average servicing portfolio count) was at its lowest point since 2000. In general, servicing churn tends to drive up direct servicing costs because of the additional work required to board and release loans.

Another positive for the bottom line in 2006: Loan balances continued to rise, which helped drive up per-loan servicing revenues. Finally, the average default rate for the prime servicing sample was 4.14 percent, only slightly higher than the 4.08 percent reported in 2005—but still low by historical standards.

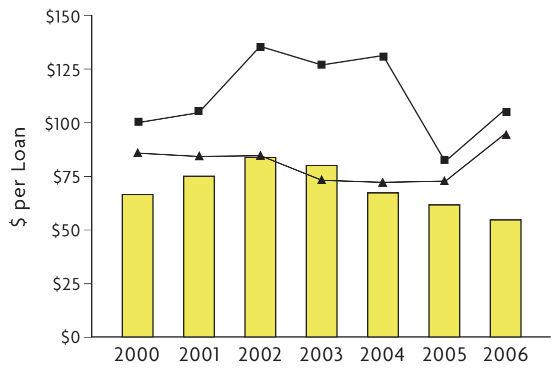
One might view 2006—particularly the first half of 2006—as

Figure **3** **Prime Mortgage Servicing Rights—Amortization, Valuation and Hedging Gains (Losses)**



SOURCE: MBA'S *2007 SERVICING OPERATIONS STUDY AND FORUM*

Figure **4** **Direct Servicing Expense by Prime Peer Group**



	2000	2001	2002	2003	2004	2005	2006
Mega	$67	$76	$85	$81	$68	$63	$55
Large	$86	$84	$85	$73	$73	$72	$95
Small/Medium	$101	$105	$136	$127	$132	$82	$106

SOURCE: MBA'S *2007 SERVICING OPERATIONS STUDY AND FORUM*

the calm before the storm in terms of portfolio performance. But there were some indicators that the tide might be turning. For example, across the board, portfolios were aging. Among the megaservicers, 42 percent of their reported servicing portfolio represented loans older than 36 months, compared with 28 percent in 2005. In addition, the reported default rate was based on the average for the entire year. As we know through the more detailed MBA *National Delinquency Survey,* defaults rose most noticeably in the last quarter of 2006.

Figure 2 displays the seven-year trend analysis of net servicing operating and financial profit for prime servicers. Net operating profit is defined as servicing and subservicing fees and ancillary income plus net interest income (escrow earnings net of interest expense), less direct and indirect servicing expenses—which we call "fully loaded expense." Continuing a trend that began with the inception of the study, net servicing operating profits rose yet again to $524 per loan in 2006. In fact, across the board for all peer groups, net operating profits rose from 2005 to 2006.

Note that net operating profit excludes several financial items relating to mortgage servicing rights—amortization, gains or losses on MSR valuation, gains or losses on MSR hedging (including the cost of hedging programs), and gains or losses on bulk servicing sales. Once we add these financial items to net operating profit, we arrive at net financial profit per loan.

Net financial profit among prime servicers dropped by 63 percent to $67 per loan in 2006 from $183 per loan in 2005. Hedge losses on MSR contributed most to the decline. Hedge losses rose to $123 per loan in 2006 (from just $2 per loan in 2005), and were only partially offset by MSR valuation gains.

Overall, direct servicing revenues net of costs generated favorable operating returns for prime and subprime servicers alike in 2006.

Figure 3 illustrates the effects of the MSR financial items to the bottom line. In 2006, $457 per loan in losses resulted from these financial items—second only to 2003, when heavy impairments hit due to widespread prepayments. The significantly lower net financial profit in 2006 exemplifies the overall difficulty in managing the volatility of the MSR asset.

Although servicing managers viewed the financial bottom line as out of their realm of control and beyond their operational responsibilities, the servicing business—financially speaking—played a diminishing role for some mortgage companies as a natural hedge to the production business in 2006.

Trends in direct costs and productivity by peer group

Overall, direct servicing revenues net of costs generated favorable operating returns for prime and subprime servicers alike in 2006. But perhaps a more interesting story can be told by analyzing the direct expense and productivity over time for individual peer groups.

Direct expenses are defined as those servicing operating expenses—personnel, occupancy and equipment, servicing technology, outsourcing, postage, etc.—related to performing the duties specified in a servicing agreement and for which a company receives a servicing fee. Figure 4 captures the seven-year trends in direct expense for the three main prime peer groups.

In 2005, all prime groups were at their lowest level for direct expense per loan since the inception of the servicing study. Comparing that with 2006, the megaservicers were the only peer group to reach a new low for direct expenses; other peer groups' direct expenses rose. Although this is not illustrated in Figure 4, we also know that subprime's servicing direct expense was $214 per loan in 2006 up slightly from $209 per loan in 2005.

As for productivity (see Figure 5), megaservicer productivity improved by 12 percent while large servicer and small/medium servicer productivity dropped by 27 percent and 14 percent, respectively. Subprime productivity also dropped to 440 loans per employee in 2006 from 479 per employee in 2005.

What accounts for the increase in direct expense and decrease in productivity for all groups other than the megaservicers? There are several theories.

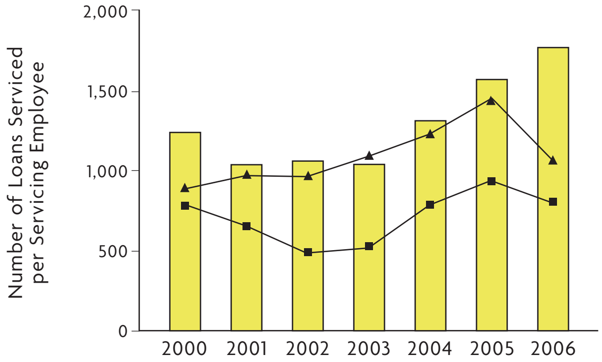
First, the small/medium servicer group changed in participant and portfolio composition. This group as a whole was more heavily involved in servicing adjustable-rate product, as well as interest-only mortgages, than in the past. Together, these types of products represented close to 50 percent of the average servicing portfolio volume in 2006, compared with 20 percent in 2005. Generally, these products tend to be more involved to service and therefore push up costs associated with training servicing personnel on the products, handling customer inquiries and ensuring proper payment allocation.

For the large-servicer peer group, direct costs likely rose in 2006 because of the heavy concentration of hybrid players. For *SOSF* purposes, we define "hybrid" as those servicers with a heavier alt-A portfolio share, a mix of both subprime and prime loans that cannot be broken out, and/or a higher than average interim servicing share.

As one might expect, the large servicers had the highest default rate and highest churn when compared with the other prime peer groups. Their default rate was 5.21 percent (compared with less than 4 percent for the other prime groups), and their churn rate was 80 percent (compared with 58 percent and 41 percent, respectively, for the small/medium and megaservicers). While not reaching the levels of the subprime *SOSF* sample (15.22 percent average default rate and 87 percent churn), the large servicers nevertheless had a portfolio mix that would justify higher direct servicing costs.

As a group, 2006 subprime direct costs and productivity were close to 2005, and costs even decreased on a repeater company basis between 2005 and 2006. The year 2007 data may show a significantly different picture based on performance to date of 2005 and 2006 vintage year product as well as changes in subprime servicers' ownership and management structures.

Figure 5 Productivity by Prime Peer Group



	2000	2001	2002	2003	2004	2005	2006
Mega	1,245	1,053	1,078	1,046	1,315	1,589	1,788
Large	900	976	967	1,096	1,237	1,461	1,067
Small/Medium	802	660	494	508	788	931	799

SOURCE: MBA'S *2007 SERVICING OPERATIONS STUDY AND FORUM*

2006 servicing costs and operational practices

As one might expect, the large servicers had the highest default rate and highest churn when compared with the other prime peer groups.

The primary focus of the *SOSF* is direct costs by function, tied to operational practices, which provide some color behind the numbers. For most peer groups in the 2007 *SOSF,* costs and employees were divided into 16 functional areas of servicing, including five different default areas—collections, loss mitigation, foreclosure, bankruptcy and real estate–owned (REO) activities. For smaller servicing shops, there was an option for only a nine-function breakout, with the major difference being there was only one comprehensive default category.

For purposes of this article, we summarized the 16 (or nine) functions into four—customer service, default, servicing systems and all other functions (including such processing-intensive functions as setups, cashiering, lien release, investor reporting and servicing administration). We also included two indirect expenses—unreimbursed foreclosure and REO expenses, and corporate allocations—to arrive at a "fully loaded" expense (see Figure 6).

Customer service: As in previous reporting cycles, the difference between prime groups in the area of customer service was minimal compared with differences in other functions. Megaservicers' slight cost advantage was primarily due to offshoring and/or outsourcing of call centers, improved Web site capabilities and sophisticated voice-recognition systems. Among all peer groups, key customer service initiatives were under way and some of the same challenges persisted. These challenges included the following:

- Continuous training and "scripting" for customer service

Figure 6 2006 Servicing Expense Highlights

	Prime Small/Medium	Prime Large	Prime Mega	Subprime
Default	$18	$21	$11	$88
Customer Service	$19	$19	$15	$30
Servicing Systems	$23	$15	$10	$28
Other	$47	$41	$19	$67
Total Direct Expense ($ per loan)	**$106**	**$95**	**$55**	**$214**
Unreimbursed Foreclosure/REO Expenses	$2	$8	$4	$6
Corporate Allocation	$17	$24	$15	$49
Fully Loaded Expense ($ per loan)	**$125**	**$127**	**$74**	**$268**
Average Number of Loans Serviced	52,912	325,001	2,728,996	251,138

SOURCE: MBA'S *2007 SERVICING OPERATIONS STUDY AND FORUM*

agents so that they understand all mortgage products and can handle all customer issues in a consistent manner.

■ Proactively contacting borrowers with ARM resets several months prior to their reset date.

■ Initiating welcome calls to ensure that new borrowers understand all terms and conditions of their loans.

■ Increasing early collections responsibilities of customer service personnel.

■ Directing customers to a "self-service" Web site or voice-response system to obtain loan information, and as a substitute for "hard copy."

■ Improving customer Web sites to allow for online payments.

■ Minimizing superfluous contact with certain groups of borrowers—such as performing, fixed-rate customers or automated clearinghouse (ACH) borrowers—by mailing fewer statements or only legally required documentation.

■ Combining escrow and principal and interest (P&I) statements to reduce postage and printing costs.

Default: The operational challenges facing default managers in the second half of 2006 and into 2007 go without saying. Across the board, default departments were focusing on intensive training of default specialists, hiring more default specialists (for collections and loss mitigation, in particular), re-examining current pooling and servicing agreements to understand loan modification capabilities, studying the state-by-state requirements for bankruptcy and foreclosure, and ensuring that best practices and standard operating procedures in regard to default were being followed. All of these initiatives affected default costs, particularly for subprime servicers.

In Figure 6, it is apparent that the default function of servicing resulted in the largest cost differential between prime and subprime peer groups. Subprime servicers averaged $88 per loan in direct default cost and $6 per loan in unreimbursed foreclosure or REO expenses—those expenses that would typically be reimbursed by a third-party investor but were not, primarily due to servicer error.

In contrast, the prime peer groups' direct default costs ranged between $11 and $18 per loan, representing, at most, one-quarter of subprime direct default costs. Even when normalized by considering average default costs per average defaulted loan, subprime servicers still had higher expenses per default compared with the larger prime peer groups—at $764 per average default, compared with $373 for the large and mega peer groups combined.

Because of different operating models between companies of like size, peer group data simply divided based on whether a servicer is generally prime or subprime, and servicing portfolio size are not perfect. With this in mind, in Figure 7 we "reallocated" the full 2007 *SOSF* sample. We divided the sample based on average default rate by company, and grouped companies into three categories—those with default rates less than 5 percent, those with default rates between 5 percent and 9 percent, and those with default rates greater than 9 percent.

The default function of servicing resulted in the largest cost differential between prime and subprime peer groups.

The result? Those servicers with average default rates of greater than 9 percent had fully loaded servicing costs that were 1.5 times more than servicers with less than 5 percent average default rates. Direct default costs alone were five times as large for the high-default servicers.

Keep in mind that the direct default costs presented in Figure 7 only represent the operational costs associated with contacting the borrower, engaging in loss-mitigation efforts, foreclosing on a loan, and so forth. As a servicer of defaulted loans, there are other costs to consider: interest expense on advances of P&I, interest expense on advances to third parties for attorney fees, property taxes and insurance, mortgage-backed security (MBS) prepayment interest expense (or compensating interest), the loss of service-fee income stream and the loss in value of the mortgage servicing rights. All of these components are incorporated into net financial profits in the *SOSF*.

Figure **7** **2006 Servicing Expense by Default Peer Group**

	Default Rate Peer Group:		
	Less Than 5%	**5%–8.9%**	**More Than 9%**
Direct Expense ($ per loan):			
Default	$13	$53	$78
Customer Service	$18	$16	$31
Systems	$13	$24	$24
Other	$35	$49	$65
Total Direct Expense ($ per loan)	**$80**	**$142**	**$198**
Unreimbursed Foreclosure/REO Expenses	$3	$8	$7
Corporate Allocation	$17	$36	$43
Fully Loaded Expense ($ per loan)	**$100**	**$187**	**$247**
Default Rate	3.00%	6.73%	16.68%
Number of Loans Serviced/FTE	1,351	780	466
Average Number of Loans Serviced	1,367,951	252,398	264,673

SOURCE: MBA's *2007 Servicing Operations Study and Forum*

Technology and other areas: Besides customer service and default, other costs relating to other servicing functions were on managers' radar screens. In the area of technology, there was increased pressure to understand servicing systems costs—which include service bureau and servicing system maintenance costs.

Among initiatives under way were handling "scripting" functions in-house or through offshore arrangements; continued customization of service bureau systems and reports to meet individual servicer needs; continued work to improve data mining for the purposes of customer retention and consolidating servicing systems to have all loan products (prime, subprime, home-equity lines of credit [HELOCs]) on a "master" system.

In addition, there was pressure to better understand indirect technology costs, which traditionally have included costs associated with general network, help-desk and other corporately allocated technology expense. For *SOSF* purposes, these allocated technology costs are part of the fully loaded servicing expense, and not direct expense. But as some mortgage companies transitioned to a more centralized approach to technology, in which all support staff are "corporate" and do not directly report to the servicing department even if they fully support servicing, cost allocations became all the more complicated.

In other functional areas of servicing—from loan setup to escrow to cashiering—servicers continued to focus on increasing efficiencies through automation, electronic payment processing and outsourcing. Servicers predicted that costs would likely increase in the areas of investor reporting and overall servicing administration because of increased involvement and/or scrutiny of various stakeholders—regulators, rating agencies, mortgage insurers, the investor community, the legal community and the media (not to mention trade associations).

This notion is supported by the fact that subprime servicers had significantly higher costs in servicing administration compared with their prime counterparts, as referenced in Figure 6. Thus, a higher default rate appears to not just affect default costs and unreimbursed foreclosure and REO expenses.

2006 results for high-cost vs. low-cost peer groups

To help to further understand the drivers of servicing cost, the *SOSF* also arranged all outputs into four "cost" groups, based on high vs. low direct servicing costs (see Figure 8).

For each of these groups, we identified portfolio composition and size, productivity, simple average FICO score, delinquency rate and churn. The average direct expense by major function and the fully loaded expense are illustrated. This breakout is yet another alternative way of presenting the data in order to better forecast, conduct sensitivity analyses and prepare for the future based on different portfolio assumptions.

Conclusion

For those who follow the *SOSF* results as published each September in *Mortgage Banking,* you may recall that last year at this time, the author pondered, "Is 2005 as good as it gets?" Based on the 2006 results, it is a mixed picture. Servicing costs were still held at bay for the most part, while net operating profits increased across the board in 2006. But early indications of more challenging times ahead for the servicing business were apparent.

MSR hedge losses hurt net financial profits in 2006—especially among megaservicers. At the same time, default rates were ticking up, servicing portfolios were aging and ARM reset dates were nearing. The idea that the servicing business could be the profit driver and compensate for declining production margins now seems a more tenuous notion, especially for subprime players. **MB**

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Figure **8** **2006 Servicing Expense by Direct Expense Peer Group**

	Low vs. High Direct Cost Peer Group:			
	Less Than $70	**$70–$104.9**	**$105–$174.9**	**More Than $175**
Direct Expense ($/loan)				
Default	$10	$14	$35	$98
Customer Service	$13	$17	$22	$31
Systems	$10	$16	$21	$31
Other	$19	$35	$53	$71
Total Direct Expense ($ per loan)	**$53**	**$82**	**$132**	**$232**
Unreimbursed Foreclosure/REO Expenses	$3	$4	$6	$7
Corporate Allocation	$11	$23	$29	$49
Fully Loaded Expense ($ per loan)	**$67**	**$109**	**$167**	**$288**
Default Rate	3.5%	4.3%	6.1%	16.4%
Number of Loans Serviced/FTE	1,883	1,066	648	413
Average Number of Loans Serviced	1,990,509	969,807	168,561	267,704
Average FICO® Score	723	720	685	621
% ARM/HELOC/Interest-Only	17.5%	36.5%	44.2%	44.5%
Loans Added and Subtracted/Average Portfolio	39.8%	66.0%	74.4%	91.9%

SOURCE: MBA's *2007 Servicing Operations Study and Forum*