Mortgage servicing — the new profit centre

Peter Knight explains the advantages of an increasingly important development of the secondary mortgage market

IN William Shakespeare's "Hamlet," Polonius advised a young Laertes off on a journey into the world to "Neither a borrower nor a lender be." Had Laertes been off to a life in the mortgage lending business, Polonius could have added, "Be a servicer."

While much has been written about the US secondary mortgage markets and mortgage securitisation in particular, there has been less international attention focused on mortgage servicing. However, mortgage servicing is an important and very lucrative element of a healthy secondary marketplace.

The servicing of mortgages has become a very attractive feature to mortgage lenders in the US who are seeking profits that are somewhat insulated from interest rate risk. Newcomers to the mortgage business are also attracted to mortgage servicing for the same reasons. They include some of the largest US manufacturing, insurance and financial service conglomerates. They are aggressively operated and hope to take a major part of the business from all existing mortgage participants, mortgage bankers as well as portfolio lenders.

What is mortgage servicing?

WHAT exactly does the servicing of a mortgage entail? The Federal National Mortgage Association's *Servicers Guide* lists the following duties and responsibilities of FNMA loan servicers. Required duties for servicing will vary, but these requirements are generally consistent with the needs of most investors:

"The servicer must take whatever action that is necessary to protect our interest in the mortgaged property as long as it is authorised to do so by the terms of the mortgage. Among other things, this generally includes:

- Paying property taxes to avoid possible tax liens.
- Maintaining adequate hazard insurance to cover damage from unforeseen casualty losses.
- Establishing and maintaining accounts for the deposit of mortgagors' funds.
- Making periodic property inspections to assure that the physical condition of the property is satisfactory or to determine needed action if it is not.
- Maintaining accurate mortgage servicing and accounting records.
- Collecting and promptly remitting any and all amounts due us.
- Taking prompt and appropriate action to resolve a delinquency, including any action necessary to liquidate a defaulted mortgage.
- Managing, marketing and disposing of an acquired property.
- Advancing reasonable amounts, if necessary, to cover expenses arising in connection with any of the duties described above."

Mortgage servicing — foundation of the secondary markets

The basic ingredient for an efficient secondary mortgage market is the ability to tailor mortgage investments for new sources of capital. This has been accomplished by meeting the needs of investors who might not otherwise be interested in investing directly in mortgages.

The first thing that may cause investors to avoid mortgages is the need to manage the loans effectively themselves and to ensure that the investor's interest is protected. This function is served by the mortgage servicer. Mortgage servicing includes collection of payments, maintenance of amortisation schedules, escrow administration, and handling delinquency and other problems that may arise.

Servicing capacity is needed to assure market liquidity, since the sale of loans and securities must be free of concern about servicing quality. For that reason, the ownership of the loan, and its servicing, are often controlled by separate entities. However, the initial investor in the loan establishes the terms of the servicing agreement. Servicing agreements can and do vary. A representative one used by Fannie Mae, the largest US mortgage investor, is highlighted in the inset.

Servicing has helped the US secondary mortgage markets grow to over half a trillion dollars in outstanding mortgage-backed securities at the end of November 1986. Hunter Wolcott, president of Reserve Financial Management Corporation, based in Miami, Florida, who serves as a consultant in the servicing field, estimates that over $800 billion of mortgages are serviced for others in either whole loan or security form.

20 Largest Mortgage Servicing Organisations

	Parent	Total Volume Serviced for Others 000s	As of
1.	GMAC	$21,761,283	6/86
2.	Lomas & Nettleton	$21,600,000	12/86
3.	Citicorp	$18,239,108	6/86
4.	Fleet Financial	$17,590,000	12/86
5.	Metropolitan Life	$14,958,546	12/86
6.	Firemen's Fund	$14,792,230	6/86
7.	City Federal Savings	$14,064,826	6/86
8.	Sears	$12,800,000	12/86
9.	Mellon Bank	$11,609,260	6/86
10.	Commonwealth Savings	$11,413,223	12/86
11.	Weyerhaeuser Corp	$10,754,822	6/86
12.	First National Bank, Boston	$10,467,575	6/86
13.	FCA	$9,861,011	6/86
14.	First Union Corp	$9,830,000	12/86
15.	Goldome FSB	$9,393,822	12/86
16.	First Interstate	$9,382,000	12/86
17.	H. F. Ahmanson	$8,753,183	6/86
18.	Meritor Financial	$7,630,468	6/86
19.	Sovran Bank	$7,253,421	12/86
20.	Chemical Bank	$6,779,000	6/86
	Top 20 Total	$248,933,778	

Source: Reserve Financial Management Corp.

Mortgage servicing—an important source of fee income

The two main areas of fee income for mortgages are origination and servicing. In a typical mortgage sale in the secondary market, the lender making the loan receives an origination fee based on a percentage of the loan. That fee is collected immediately, and should that lender continue to service the loan, he will earn a servicing fee representing a portion of the interest income generated by the mortgage. These fees vary from ¼% to over ½%.

Servicing is one of the best profit opportunities for lenders in the mortgage process. The profits from mortgage originations vary with interest rates and/or seasons in many areas. In addition, the personnel-intensive nature of originating loans means higher overheads. The servicing of mortgages, on the other hand, is less affected by the vagaries of interest rates and lends itself to computerisation and very efficient staff operations. Computers have enhanced the attractiveness of mortgage servicing by increasing profitability. Without computers, servicing could not be the profit centre now established by so many institutions.

In addition to being a stable source of asset-based income, servicing also provides one of the few remaining sources of stable long-term deposits in the form of escrow accounts. These accounts are established to pay a mortgagor's taxes and insurance and range from between 1% and 2% of the unpaid balance of the loans being serviced. Most states do not require interest to be paid on these escrows, which is a significant attraction for servicers.

Servicing loans also gives lenders a strong relationship with the mortgagors, opening up possible new business. Many servicers attempt to cross-sell a wide range of financial products to the borrowers on the loans they service.

However, servicing is not immune to rate risk. Rather, the risk is inverse to the standard rate risk for the savings industry. As rates fall, borrowers refinance higher rate loans and mortgages prepay. Servicers that do not aggressively recapture their mortgage servicing as it refinances may see an evaporation of valuable servicing rights, some of which may have been recently purchased with a long-term expectation.

The trading of mortgage servicing rights

Finally, servicing is now a liquid commodity due to today's mortgage market standardisation of loans and procedures as well as new computer technology. The trading of servicing rights has become a multi-billion dollar market. Companies buy and sell servicing rights on existing mortgages, and the high degree of liquidity of servicing approaches the liquidity of the mortgage investments themselves. Over $100 billion of servicing rights traded hands in 1986.

In fact, the servicing market has recently gone from a sellers' to a buyers' market. Two years ago, servicing sold for more than 2% of the amount of the balance of loans to be serviced. This was more than twice what the traditional going rates were. After the wave of refinanced mortgages in the past years, these prices have fallen somewhat, but are still in the 1½% range.

In this high-priced market, it is important that buyers only seek servicing based on careful planning. Hunter Wolcott advises purchasers first to define the objectives of an acquisition programme. This analysis starts with an assessment of an institution's strengths. The purchase programme must be founded on the institution's capabilities, which include staffing, systems, procedures, capacity and other factors

→ 38

←37
such as geographical location of staff.

Then the institution must define the objectives for purchasing the servicings most compatible with the institution. Of course, profitability of servicing is paramount. To be profitable in servicing, an institution must reach a critical mass of mortgages being serviced to offset expenses such as new computer systems. Therefore, the volume of servicing desired must be ascertained.

Other factors also affect the profit potential of mortgages to be serviced. Location is a big factor in this equation. If all the loans are located in a similar region or state, the profitability may be higher, especially if the lender already has support personnel in the region. On the other hand, high delinquency rates in a given area can make servicing more expensive.

State and local laws must also be examined. State laws affecting foreclosure proceedings, escrow accounts and property taxes all affect servicing. For example, when California passed Proposition 13 limiting state property taxes, it also reduced the attractiveness of servicing mortgages in California since escrows for taxes would be lower.

The last major factor to be weighed, according to Mr Wolcott, is the type of servicing. Adjustable rate mortgages add new complexities such as negative amortisation, variable payments and other factors which increase the lender's servicing responsibilities and costs.

In the case of servicing for mortgage pools sold through the issuance of mortgage-backed securities, there are other important distinctions. Pass-through certificates, in which principal and interest must be advanced, are potentially more expensive to service than modified pass-throughs in which only interest must be advanced. Individual investors may also have policies that affect servicing.

For example, if an investor charges a fee to anyone who subsequently transfers servicing, this consideration should be built into the purchase price of that service.

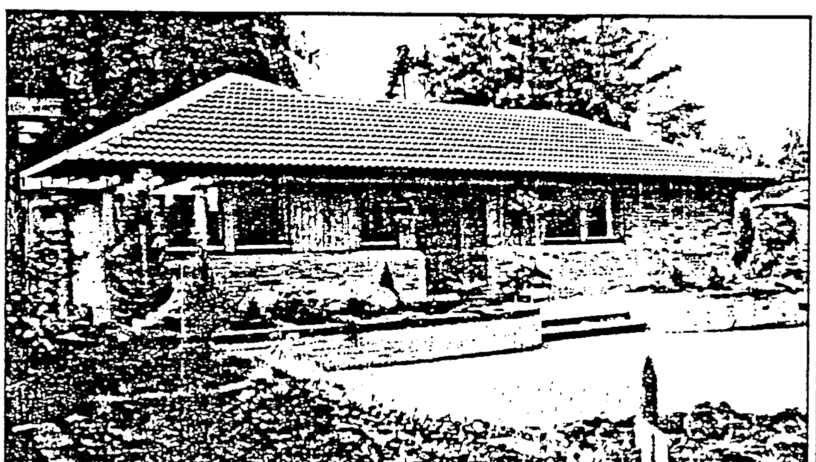
Industry consolidation

The attractiveness of servicing in terms of profitability, cross-selling opportunities and liquidity has attracted the largest US corporate names to the business. The table (page 37) lists the top 20 servicing firms, and many recognisable, non-mortgage names appear on that list, including Sears, Citibank and GMAC (General Mortgage Acceptance Corporation).

A recent study, "The Consolidation of the US Mortgage Industry," published by the SMR Research Corporation in Budd Lake, New Jersey, examines the trend to a national market with fewer, bigger players.

Stuart Feldstein, president of SMR, commented, "The largest players in the market are growing two to three times as fast as the overall market, which is symptomatic of an industry going through dramatic consolidation." The figures reflect this trend as the growth in servicing by the largest players has outpaced the growth in the volume of outstanding loans.

	1983	1984	1985
Mortgage Debt Outstanding	$1.81 tri	$2.02 tri	$2.25 tri
Change from Previous Year	—	11.6%	11.4%
Portfolio of 20 Largest Mortgage Servicers	$133.2 bn	$152.8 bn	$209.4 bn
Change from Previous Year	—	14.7%	37%


Servicing the mortgage on this attractive home would be a useful way of earning fee income.

Outlook for servicing market in other countries

Just as secondary markets are now spreading worldwide, it can be expected that mortgage servicing as a separate and profitable operation will develop. This will occur over time, as the markets themselves develop. Eventually, in countries with an active secondary market, mortgage servicing will provide traditional suppliers of mortgage credit with new ways to earn fee income while opening the door for additional competitors in the mortgage business. ■

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