Solving Servicer's Problems

There is a compelling specialty solution to servicing's costly "Catch-2010."

By Steven Horne

If Time Magazine had a mortgage industry version of its "Person of the Year" edition, the person recognized (and it's often not an honor) might actually have been an entire business segment—loan servicing. Much maligned for some highly public missteps, primary loan servicers have seen far better years. Unfortunately, not a lot will change for 2011 if their strategies remain the same; fortunately, a growing number of lien holders and investors are reacting to the truth of the current situation and desire change. Whether they embrace change remains to be seen, but servicers will be better off as their tactics adjust in 2011.

It's not the servicers' fault, ultimately. In many respects they are the victims of their own success over the course of generations of relative stability in the mortgage industry. If the ship is sailing well, why redesign its architecture? Understandable, if the problem of dealing with weather seas never arises, but that has not been the case over the last few stormy years, and everyone—including servicing's clients—has noticed.

The basic business model for loan servicers really hasn't evolved much since the 1970s and early 1980s, when they shifted from ledger card management systems over to computer-fueled practices. Servicers handled what amounted to an enhanced accounting function, accepting and posting payments, dealing with occasional inquiries, some basic reporting and so forth. When a borrower was late on a payment, little initial action was taken for the simple reason that the payments almost always showed up, and besides, there was good money in late fees. If the delinquency persisted another month, then a polite letter was in order. Give it another two weeks or so, and a polite phone call would follow. Actual defaults were few and far between, and only a tiny fraction would go to foreclosure.

As the GSEs grew to represent over a third of the loan market, not much changed, except that fewer companies elected to service their own loans and servicing became concentrated among a smaller number of megaservicers. Subprime became a meaningful and lucrative part of the market in the 1990s, and those loans were similarly serviced, though the phone calls became more frequent and noticeably less amiable. Most defaults became cured on the way to the foreclosure department; if not, rising home values largely eliminated the possibility of loss even in the event of a foreclosure.

The basic compensation model was unchanged from the earliest days too, as was the technology used for the servicing shop. It automated a few tasks, kept records well, and included conversation logs that were especially important for those subprime "story loans." Servicers were paid somewhere between 25 and 50 basis points to perform their functions, and as recently as the early 2000s, servicing was a business that a lot of people wanted to be in. It was uncomplicated.

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Looking at the landscape today, it seems less idyllic and more like a nightmarish battlefield from the Napoleonic Wars, covered with blood and anguish. Servicers were completely unprepared for the onslaught of delinquencies, much less defaults, and the results have made headlines for months. The takeaway from all this is inescapable—primary loan servicers are great for handling accounts that pay as agreed and are fully capable of working delinquent loans as long as there aren't too many of them. But they are undermanned and outgunned when it comes to working with boatloads of defaulting borrowers and handling foreclosures or its alternatives. Once again, not their fault—it's baked into their business model.

It is a classic "Catch-22." If you recall Joseph Heller's novel from sophomore English class, it's the story of a WW II bombardier who has been on too many missions and is experiencing shell shock—what we now understand is post-traumatic stress syndrome, or PTSS. He refuses to fly and claims to be crazy, but is told that not wanting to fly missions is entirely sane, and therefore he cannot be crazy and must fly. Servicers want to handle defaults, but they can't because they don't have the money to pay for the extra work and expertise, based on their compensation structure. They can't charge the extra amounts necessary to handle these loans fully because that would provide an incentive for them to cause loans to go into default. Think of it as loan servicing's "Catch-2010."

Everything the loan servicer does that is outside their basic sphere is a cost that has no way to generate revenue, so those things are not going to get the resources and attention. This applies to virtually all things related to default, among them two areas that received a lot of attention in 2010: foreclosure affidavits and short sales.

Foreclosure-Gate or the "robo-signing" scandal—call it what you will. Regardless of your choice, bringing it up is the fastest way to cause dyspepsia in any gathering of servicing executives. It was their worst nightmare, all spread out for the world to see, and it remains the scandal that keeps on scandalizing. The industry has an obligation to follow the rules and execute foreclosure paperwork by the numbers to satisfy the legal requirements of the system. True, the loans were defaulted upon by the borrowers, not the servicers, but that's not the issue. Not following the rules is, and it matters not whether there was any real intent to commit fraud—those who don't follow the rules are culpable. I can only imagine what the penalties might be by the time the lawyers finish cleaning up the battlefield. As a lawyer myself, I see big numbers in this fiasco, all of it coming from the perceived deep pockets of servicers, mortgagees and investors, along with some poorly performing non-servicing third party service providers.

How might it have been avoided? Like most of the servicing tasks that are ill suited for primary servicers, foreclosure management is perfectly matched up with the rising segment of specialty and component servicers. They're not non-servicing third party providers, they are loan servicing specialists, and as such understand the rights and responsibilities of all stakeholders in the transaction. They handle all types of liens, and are typically compensated only when they succeed at their tasks—so no robo-signing shortcuts are encouraged. Most importantly, there is no inherent conflict of interest. Moreover, there are growing numbers of specialty and component servicers out there to handle the load, so scalability is not an issue, either. In short, steering these transactions to specialty servicers would have meant a few extra dollars initially in the process, but many, many millions of dollars in savings over the final tally.

Beyond the robo-signing situation, using specialty servicers offers the very real prospect of avoiding foreclosure altogether. Many of them focus on foreclosure alternatives, including (but not limited to) short sales. Among these is a servicing specialty that is as much of an art form as a business practice: turning non-performing loans (NPLs) into re-performing loans (RPLs). Foreclosure loss severity has been on the rise and, with the ambiguity brought to the situation by Foreclosure-Gate, servicing rights owners and other interested parties, like mortgage insurers, are looking for alternatives that don't immediately involve a sizeable, inevitable loss.

This sort of specialty servicer does what the primary servicer does, except that it is performed in a fashion bearing little if any resemblance to the way the primary servicer operates. At the traditional servicing shop, for example, close tabs are kept on the borrower contact person by either their telephony software or live supervisor to make certain not too much time is being spent on the phone with delinquent accounts. In shops like ours, it is exactly the opposite: we need to know the borrower's situation and there is no better way to build a relationship than listening to their story with patience and empathy. We actually compensate our resolution specialists based on spending more time with borrowers, not less. No primary servicer can afford to do that, but since specialty servicers are typically paid on success, it's in our DNA.

All the additional time spent allows us to evaluate a non-tangible that either makes or breaks the chances for a long-term re-performing loan situation, something we call "psychological equity." This factor recognizes the non-monetary investment the borrower has in their neighborhood. The local schools, the friends on the block, the youth sports teams, the neighborhood kids who are constantly in and out of the house; these are all contributors to the borrower's psychological equity. My experience has been that if the borrower is sufficiently motivated to stay in the home and make some sort of payment, the chances are excellent that foreclosure can be avoided and a long-term modification can be successful. How successful? In the last two years, about 80% of our mods have lasted twelve months or more.

Once the loan achieves full re-performance, the mainstream servicer gets it back, and a loan with zero or negative value is once again a performing asset. This level of personal attention is simply not within the capabilities of a primary servicer, and with the very nature of foreclosure called into question, it can be an attractive alternative for everyone involved. So not only might Foreclosure-Gate have been avoided by using alternative servicing approaches, many of these loans might never have required a foreclosure affidavit in the first place.

What about short sales? Ask any real estate professional about their short sales experience and you could be in for a monumental tirade on dealing with servicers. Offers ignored, phone calls unreturned, e-mails unanswered and other unflattering behaviors are certain to be described. With a growing housing inventory and the previously mentioned increasing severity with uncertain foreclosure actions, the short sale is a strategy with a future. But they take special handling, and blitzed servicing staffs are seemingly more concerned with staying abreast of other duties, even if those tasks aren't going to save mortgagees from greater losses, as short sales often can.

Enter the specialty servicer, the go-to person for things that fall outside the normal servicing routine, like short sales. Specialty and component servicers handle more short sales than ever before for two good reasons. First, they have the capacity and skill set to work with all parties to address the considerable needs of each transaction. There are a number of time-consuming steps to be taken, negotiations to conduct and stakeholders to orchestrate with short sales, and specialty shops are built for this purpose. Secondly, the entire orchestration process is best handled using technology as a tool to conduct the transaction, and specialty servicers have those tools at their command. Primary servicers, as mentioned earlier, are still mostly saddled with old-school systems that were never designed for these tasks.

Leading specialty servicers have the advantage of specialized and often proprietary technology tools, including Web-based transaction management platforms designed to handle short sales. These platforms are new within the last few years, and bring communication levels among short sale stakeholders to an entirely new plane. All parties can go to their own secure webpages and see precisely what has been accomplished, what is yet to be delivered and when the closing is scheduled. Junior lien holders are dealt with, transaction leaders can order needed services instantly, and the process is sped along to a successful conclusion in as little as a third of the time normally expected.

Although specialty servicers have been experiencing remarkable growth throughout 2010, the industry will truly be taking off in 2011 as awareness spreads among concerned investors, lenders and servicing executives. With several million delinquent and defaulting loans still out there, the industry clearly needs assistance from experienced professionals with demonstrable track records. Technology plays a key role in all this, enabling smaller numbers of skilled people to do the work of many while offering the extremely fine hands-on service levels required for success.

Specialty servicing is more than simply a solution to the industry's persistent problems in balancing its own interests with those of its stakeholders and borrowers. It's the best way to keep "Catch-2010" where it belongs: in the past. ❖

About The Author

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