Servicing's Tough New Challenges

BY NEIL J. MORSE

Mortgage servicers may be forgiven for complaining these days that they sometimes feel like the "shovel brigade" marching in the parade behind the mounted horse guard. ■ After several record-setting origination years—driven in some cases by a showering of nontraditional products upon some overextended borrowers for properties now declining in value—it's become a tougher slog for companies trying to collect principal, interest and other payments on all those new loans. ■ Toss in a rising tide of fraudulent activity, and the amount of post-closing clean-up activity servicers are encountering only intensifies. ■ "Origination quality has really declined," laments Bob Norrell, senior vice president, Litton Loan Servicing, Houston, a prominent subprime servicer with 400,000 loans on its books. The company also does some interim servicing (an arrangement whereby the loans' owner may "park" some loans or temporarily hire a servicer, usually for as little as 30 days or as long as nine months).

Servicers are facing several challenges in 2007. Delinquencies are up, home prices are down and compliance demands are on the rise. Plus, growing numbers of nonprime borrowers require much more hand-holding when adversity hits close to home.

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Norrell draws a straight line from what he sees as front-end laxity to trouble on the backside, ticking off the time-bomb factors that, he says, have become more commonplace: Low FICO®-score borrowers, early-payment defaults (EPDs), loan buybacks and real estate–owned (REO) properties. And, if that laundry list were not enough, he throws in the estimation that, "In the subprime world, somewhere between 30 [percent] and 35 percent of all loans have some aspect of fraud in them."

It comes down to a turn in philosophy, according to Norrell, who reckons that in raising homeownership to the current, record-high 70 percent range, too many borderline customers, loans and collateral have been sucked into the pipeline.

In sum, he declares: "The country cannot have [all] good, prime borrowers in that [percentage] range."

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The comeback from those with a somewhat different perspective is that some loan servicers have failed to update their methods to keep up with a different origination environment.

"Some servicers have not done contingency planning for a changing market," says Javid Jaberi, senior vice president, asset performance, in the Dallas office of Horsham, Pennsylvania–based GMAC Mortgage. Jaberi identifies "capacity" as a key issue for successful servicing going forward.

"Without adequate pre-planning and management, some servicers will experience higher levels of defaulted loans, delinquencies and, ultimately, foreclosures," says Jaberi.

GMAC has become a top-three subservicer in the industry, with $51.8 billion worth of unpaid principal balance under management for others, as of late 2006. Its direct-servicing book totals another $350 billion, one-sixth of which is subprime.

Tom Donatacci, GMAC's senior vice president of business development, describes the company as "unusual, in that it covers prime and subprime as both a servicer and subservicer." The latter describes a servicer that performs ongoing servicing activities under an agreement with the contractually responsible servicer—sort of like a substitute teacher in a classroom.

Donatacci is responsible for both the subprime and prime subservicing businesses. He is located in its Paramus, New Jersey, office. Donatacci has worked in the mortgage servicing sector for some 20 years, but he labels the growth of business that occurred in the last four years "unprecedented."

Early-payment defaults on the rise

The downside of all that expansion is particularly apparent in rising loan buyback demands and early-payment defaults (EPDs)—the former, a demand from investors that originators take back loans, which turn out to have faulty documentation or other flaws deemed to have abrogated the contractual agreement between the two.

Michael Pfeifer, a partner in the law firm of Pfeifer & Reynolds LLP, Orange, California, says the secondary market is "looking at these pools and asking: 'What is it exactly that the investors in these things are buying; what is it exactly that they're getting?' They're not supposed to be junk bonds."

Pfeifer says, "If a property goes down [in value], it's hard to refi out; we've been getting by with that in a rising [property-value] market. A rising market has covered a multitude of sins. Now, though, the repurchase issue will become acute."

In addition, the swell of early-payment defaults "has brought performance of all loans under a much more finely tuned microscope," says GMAC's Donatacci, who finds that "a lot of firms buying mortgage loans have turned up their focus on these defaults and have become more exacting in holding sellers of product to the contractual rules in place."

It is another way of saying that they are playing hardball—and with good reason. "We've seen the EPDs for loans we subservice go from 1 percent to 5 percent," says Donatacci. "As originations slow and firms try to retain profitability, they are more careful about rejecting product that doesn't suit their criteria, in order to maintain returns."

Damien Weldon, director of collateral risk analytics for First American LoanPerformance, San Francisco, says this increased stringency is being driven by a "general feeling out there that the next foreclosure cycle is already manifesting itself."

Weldon sees "the battle for performance" being won or lost in the early-stage collections.

Nipping delinquency in the bud

"Servicers are trying to become even more proactive than usual—jumping on problems faster and sooner," says Weldon, recognizable by the Irish lilt in his voice and respected for an ability to grasp the big picture.

He notes, "In the past, if a loan payment was 45 days past due, the servicer would do a 'drive-by.' Now, however, they'll do it at 30 days." But even before that stage, he says, "Companies are reaching out to late-remitting borrowers and being proactive at 15 days, not 30."

This is very much the story at Celink, Lansing, Michigan, which services all types of loan products but specializes in niche markets such as reverse mortgages, nonconforming first and second mortgages, and almost any other subordinated-lien loan. The company is currently servicing $300 million in subprime loans in a total portfolio of $807 million—approximately 35,000 loans in all.

Celink Chief Executive Officer John LaRose, a familiar figure in subprime circles, says, "We're seeing a much more ambitious posture when there is a default. In the past, we'd send out a notice of intent to foreclose at the 60th day—now it goes out at the 30th day" following a missing payment. And, LaRose adds, "When a borrower is two payments down," off come the gloves. "We notify them that we intend to foreclose."

LaRose says this is no longer "just a collection tool," but rather a real effort to "get everything lined up so the foreclosure can be much quicker" and the occupants can be moved out of the house "so lenders can recoup their investment," he says.

Confirming this heightened vigilance, Norrell reports that Litton has been on "an aggressive loss-mit campaign" since last

summer, expanding from seven calls a month on past-due accounts to 30—a necessary move, but one that does not come cheaply. "It drives our costs through the roof," declares Norrell, declining to be more specific.

The dollars and cents

Along with more "hand-holding" required in subprime lending and servicing, there is also a greater cost to manage such portfolios.

David J. Miller Jr., senior vice president, business development director, with Cenlar FSB, Ewing, New Jersey (just outside Trenton), puts some numbers on the table.

A subprime loan, he calculates, costs $20 to $50 a year more to service, "but [actual costs] depend on the characteristics of the [overall] portfolio." Not surprisingly, loan files with added wrinkles such as a foreclosure or bankruptcy proceedings cost even more to handle.

While continuously advancing technology has helped rein in expenses, Miller says old-fashioned blocking and tackling is still necessary. "We still need to get a customer on the phone" much more often "to collect on a subprime loan," Miller says. He says company personnel must dig deeper to find reasons for a default or other problems, and determine a customer's ability to repay.

In the past, Cenlar serviced mostly alternative-A loans, until adding its downstairs neighbor (subprime) in the last two years.

On the strength of significant growth in subprime lending, Cenlar "was finding [more] opportunities with partners who had a need for that servicing," explains Miller. "There were more companies going down the credit curve," he adds, noting that "even credit unions" are now offering such products, which has drawn the attention of business observers and federal regulators concerned about the ramifications.

The outlook for foreclosures

William Longbrake, a senior policy adviser to the Financial Services Roundtable, Washington, D.C., which represents interests of the securities, banking, investment and insurance sectors, has said that mortgage defaults could "snowball in the early months of 2007"—a situation that bears close watching, he advises.

The Mortgage Bankers Association (MBA), meanwhile, reports that mortgage foreclosures have risen as higher interest rates and energy prices make monthly loan payments harder for some homeowners to make. Doug Duncan, MBA chief economist and senior vice president, told a mid-January press briefing in Washington that he had not seen evidence that the recent rise in delinquencies was coming from the growing share of nontraditional mortgage products, but instead was traceable to factors such as the normal market behavior of aging loans.

Adding his powerful voice to the mix, Treasury Secretary Henry M. Paulson Jr. publicly acknowledged at an Office of Thrift Supervision (OTS) meeting in December 2006 that mortgage delinquency and foreclosure rates were on the rise, and worried that "the impact could be greatest on low-income families" that took out higher-interest and more risky loans.

Last fall, in a widely anticipated announcement, five federal regulatory agencies issued a single policy document called *Interagency Guidance on Nontraditional Mortgage Product Risks,* addressing concerns related to mortgages that permit borrowers to defer repayment of principal—and sometimes interest, too.

A nearly 9,000-word declaration, the guidance was issued jointly by the Office of the Comptroller of the Currency (OCC), the Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation (FDIC), the OTS and the National Credit Union Administration (NCUA). It established several safety measures for lenders that are designed to lessen the "risks posed by these [nontraditional] loans."

Subsequent to issuance of the guidance, elected officials, consumer groups and others have suggested expanding it to include all hybrid adjustable-rate mortgages (hybrid ARMs). In particular, products such as the 2/28 ARM have been targeted for inclusion.

In response, industry groups have opposed this expansion. MBA, which had expressed "strong concerns" about certain features of the guidance prior to its release, has continued voicing its opposition to any expansion of the document that would include all ARM products that produce a negative-amortization result.

Kurt Pfotenhauer, MBA senior vice president for government affairs, told the January press briefing that if the regulators are determined to move forward with an expansion of their guidance, MBA is urging them to publish the expanded guidance for a new round of public comments.

In addition to recommendations on underwriting standards, collectibility of the portfolio and sufficient consumer information, the federal guidance on new mortgage products also addressed servicing.

In a January letter to several U.S. senators who backed such an expansion, MBA Chairman John M. Robbins, CMB, said it would distort the definition of what a nontraditional product is, and would limit the options available to homeowners who need alternative credit products to purchase a home. In a January letter, the Consumer Mortgage Coalition, Washington, D.C., also urged government officials to weigh carefully any decision to include hybrid ARMs such as 2/28 ARMs in any expansion of their earlier guidance.

Regulators mandating strong servicing practices

In addition to recommendations on underwriting standards, collectibility of the portfolio (so that these remain performing assets) and sufficient consumer information, the federal guidance on new mortgage products also addressed servicing. The federal agencies also are asking companies to "apply sound practices in valuing the mortgage servicing rights of nontraditional mortgages."

Further, they stated that "since many nontraditional mortgage loans permit a borrower to defer principal and, in some cases, interest payments, for extended periods, institutions should have strong controls over accruals, customer service and collections."

Any "policy exceptions made by servicing and collections personnel should be carefully monitored to confirm that practices such as re-aging, payment deferrals and loan modifications are not inadvertently increasing risk," the agencies note in their final guidance.

Because payment-option ARMs require higher levels of customer support than other mortgage loans, the guidance recommends "customer service and collections personnel should receive product-specific training on the features and potential customer issues."

Also, it calls upon "those institutions with material mortgage banking activities and mortgage servicing assets [to] apply sound practices in valuing the mortgage servicing rights of nontraditional mortgages in accordance with interagency guidance. This guidance requires institutions to follow generally accepted accounting principles [GAAP] and conservatively treat assumptions used in valuing mortgage servicing rights."

The guidance is but the latest government effort resulting in tougher regulation of mortgage servicers. It follows earlier Securities and Exchange Commission (SEC) pronouncements that were issued under a beefed-up Regulation AB, which has broadened the definition of a servicer and created minimum servicing criteria that are intended to be applied to a broad range of asset-backed securities (ABS) assets, including mortgage-backed securities (MBSs).

Servicers facing Reg AB compliance

"Reg AB," which took effect Jan. 1, 2006, represents an effort by the SEC to increase the transparency on structured-finance securities "by expanding, clarifying and formalizing disclosures and reported information about security collateral to ABS investors."

Servicers have until the end of March 2007 to produce their compliance assertions and accounting firms' attestations for 2006 calendar-year operations.

If it is determined that a servicer is noncompliant with Reg AB, "it would be viewed as if [they were] noncompliant with other laws and regulations, and [they] could have their servicer rating downgraded," says Thomas Crowe, director of Fitch Ratings, New York.

Crowe says, "Many servicers are still developing the attestation programs for themselves and other relevant parties, and determining additional reporting requirements. Additionally, many servicers are also still in discussion with accounting and law firms, which are anticipated to play a considerable role in shaping the servicer's interpretation of reporting requirements for Reg AB," according to Fitch.

Reg AB separates minimum servicing criteria into four categories:

- general servicing considerations;
- cash collection and administration;
- investor remittances and reporting; and
- pool asset administration.

Reg AB reporting requirements significantly expand upon the earlier Uniform Single Attestation Program for Mortgage Bankers (USAP) certification. USAP, up until now, has been generally accepted as the residential mortgage industry's benchmark for demonstrating compliance with minimum servicing standards, according to New York–based Standard & Poor's (S&P) ratings agency.

Despite a proactive stance by servicers to meet minimum servicing requirements brought on by Regulation AB, Fitch stated in a report released last summer that "achieving compliance will remain a challenge in the first year of the law."

Servicers have until the end of March 2007 to produce their compliance assertions and accounting firms' attestations for 2006 calendar-year operations.

At S&P, Director Mike Gutierrez sounds a bit more relaxed. "We're not just going to automatically downgrade a servicer that has exceptions," he says, adding, "It'll be a matter of weeks" after the deadline before his and other firms make any declarations about certification.

Gutierrez heads up the U.S. servicer evaluation practice for S&P, which has 316 rankings covering the residential, commercial and ABS servicer business. This is the most number of rankings, he says, followed by Fitch and New York–based Moody's Investors Service.

He acknowledges there will be lingering "questions about how [the regulation] will affect third-party vendors [subservicers]." His view is that these third-party players will be more impacted than regular servicers. It may prompt some to "think about selling loans servicing-released" and not be bothered with the Reg AB requirements, he says.

A major compliance challenge

The one-two punch of federal guidance over nontraditional mortgages on the front end and Reg AB on the back end could make 2007 the most challenging year for servicing compliance in the mortgage industry for quite some time.

Penny Paplanus, CMB, vice president of compliance, New Century Financial Corporation, Irvine, California, points to a section of the federal guidance that addresses servicing and disclosure, specifically on the monthly statements for payment-option ARMs.

That portion promotes "true understanding" by consumers of the varying payment options contained in the transaction "so they really understand what that means," she says, noting that "not all systems are set up to do that."

For that reason and others, Paplanus says unabashedly: "It's going to get very ugly in servicing."

The biggest part of the problem, she says, is that borrowers in trouble typically retreat rather than reach out to their creditors for help navigating rough waters.

Lenders are perceived as the villains, says Paplanus, as delinquent borrowers "tell their moms [when there's a problem]. They tell the guy down the street. They tell everybody that's moving, but they don't come and talk to us," she says, despite the fact that "we have multiple ways to assist them. But they're just afraid because the mortgage loan is the biggest thing in their lives—so they're afraid to call."

But anxiety does not account for the calculated avoidance

efforts taken by some delinquent borrowers. "Borrowers are smarter today, and their attorneys have sold them on how to stay out of foreclosures. It's a fight all the way through," Norrell complains. He adds, "A lot of advocacy groups are also battling us every day, accusing servicers of kicking people out of their homes and hurting communities." To which, he says: "Hey, I didn't make the damn loan! How am I supposed to just give people their homes?," he asks rhetorically, noting for historical perspective, "We didn't contend with that 10 years ago."

Connecting with troubled borrowers

On a calmer note, servicer Daneen Sparcino of Bank of America is confident that her staff can "find ways to make the connection" with late-paying customers. Sparcino, vice president and senior operations project consultant in the Getzville, New York, office of Charlotte, North Carolina–based Bank of America, describes one effort in this regard—a pilot program the bank has entered into with counseling agencies "to make that contact with the customer."

Additionally, Sparcino points to a television commercial sponsored by The Financial Ad Council set to air in the second quarter of 2007, which "will talk about foreclosure prevention." The joint industry effort to get the word out on this problem, according to Sparcino, represents a new era of cooperation.

"I think it's really nice that many lenders are working together now instead of in a competing environment; we're actually joining forces to get the word out," says Sparcino. In addition to internal industry collaboration, lenders are joining forces with community organizations to reach borrowers in trouble.

Once such group, the Association of Community Organizations for Reform Now (ACORN), Chicago, is actively working with some servicers, going into neighborhoods and knocking on doors of those borrowers who have proven toughest to reach. Founded in 1970, ACORN bills itself as "the nation's largest community organization of low- and moderate-income families, working together for social justice and stronger communities."

A key question for servicers, as Weldon sees it, is "when to put a property into foreclosure and at what price."

"Counselors offer a sympathetic, informed ear," says Bruce Dorpalen, national director of housing counseling in the Philadelphia office of ACORN Housing Corporation, explaining the reason for his group's involvement—and likelihood for its success.

Dorpalen believes this community outreach is becoming mandatory. "Otherwise, customers feel totally disempowered," he says. "They feel like they are giving their future up to some stranger."

First American LoanPerformance's Weldon notices the trend toward collaboration between servicers and independent credit counselors, who, he says, "can be unbiased and restructure financial arrangements to help borrowers meet their obligations." Weldon expects an increasing number of servicers to work with independent counselors, especially on cases involving subprime loans.

Weldon says servicers must "increasingly adopt innovative ways" to take on the delinquency problem, using methods like call-center technologies and predictive dialers. In particular, Weldon says, "they need to obtain valuation information [i.e., the value of the collateral backing the mortgage] of the kind that is often insufficient."

In an effort to remedy that, he conducted a study late last year that looked at early-payment default behaviors over the last five years, using information accrued on First American's database of loan and servicing information.

The study sought to identify lenders with high rates of EPDs relative to total origination value, Weldon says. It also looked at what he calls "the serial REO effect"—that is, properties that go in and out of foreclosure, "independent of which lender made the loan."

Weldon's early findings indicate "hard-core properties in certain areas are basically setting the floor for REO pricing." About 8 percent of all EPDs between 2000 and 2006 have at least one previous foreclosure or foreclosure action, he notes, leading him to believe that "lenders have to look at that situation and not focus on borrowers' previous behaviors. They have to take a more aggressive real estate focus, as opposed to a loan- and asset-focus. With rising EPDs, it's a real estate decision and business. These companies are no longer just in the mortgage business anymore."

Deciding when to foreclose

A key question for servicers, as Weldon sees it, is "when to put a property into foreclosure and at what price." He says, "They may not know what the [larger] REO situation is in that local area, so when a loan 'goes south,' an REO property will end up selling at a discount compared to a non-REO property. The big thing is determining the different price amounts, and that will vary according to market conditions."

Weldon cites, for example, the last 12 months in the so-called "Rust Belt"—the Midwest states of Ohio, Michigan, Illinois and Indiana—which have rising EPDs, particularly in subprime that can be linked to the flat economic picture there, resulting from employment declines in the auto and support industries there.

Further, in the last three to six months, subprime delinquencies have crept up in areas of California, notes Weldon. "It's critical to know how a market is trending for the future," he suggests, because as REO inventories increase, it becomes Economics 101—all this activity further pushes down the "REO discount."

Clearly, risk analysts such as Weldon and servicing professionals such as Celink's LaRose are witnessing a tougher servicing climate this year, so it is understandable that they may be feeling just a bit grumpy. As LaRose puts it: "Servicers are at the end of the food chain. We get what's left over, and the blame when things don't go well." **MB**

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