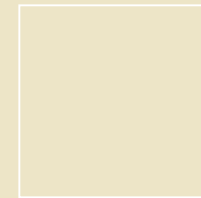


Mortgage Servicers: Impediments and Possibilities



Breck Robinson

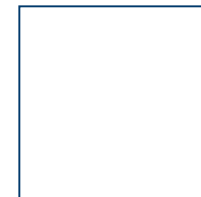
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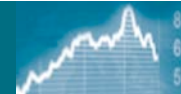
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- **They do not represent an official position of the Federal Reserve Bank of Richmond or the Federal Reserve System**



The Role of Mortgage Servicers

- Bill and collect payments and fees from mortgage holders
- Monitor non-discretionary payments (e.g. taxes, insurance)
- Manage delinquencies to minimize losses and maximize asset recoveries, acting as the agent of the trustee
- Manage mortgage insurance recoveries, if applicable
- Advances on delinquent loans
- Remit payments to trustee
- Provide required information to trustees/investors regarding the performance of asset pools



Top 10 Subprime Servicers

Rank	Company	Location	Servicing Volume (\$ in Millions)		Market Share*
			12/31/2007	12/31/2006	
1	Countrywide Financial Corp.	Calabasas, CA	\$ 112,688	\$ 119,060	8.67%
2	Chase Home Finance	Woodcliff Lake, NJ	73,735	83,837	5.67%
3	CitiFinancial (E)	Baltimore, MD	67,000	64,250	5.15%
4	Option One Mortgage Corp.	Irvine, CA	55,098	69,039	4.24%
5	Ocwen Loan Servicing, LLC	West Palm Beach, FL	52,748	52,160	4.06%
6	Wells Fargo & Company	San Francisco, CA	52,300	51,321	4.02%
7	Ameriquest/Citigroup (E)	Orange, CA	50,500	65,000	3.88%
8	Home Loan Services, Inc.	Pittsburgh, PA	47,443	49,545	3.65%
9	Homeq Servicing Corp.	North Highlands, CA	46,904	44,424	3.61%
10	Washington Mutual	Seattle, WA	43,602	19,196	3.35%
Top Ten Total			\$ 602,018	\$ 617,832	46.31%

Source: Mortgage Servicing News

* Percent of Market based on estimated market size of subprime mortgages at \$1.3 trillion



Economic Incentives

- MAXIMIZE CASH FLOWS TO INVESTORS
 - Foreclosures may maximize cash flows => talk about this more later
- Compensation structure for servicers
 - Revenues: receive 25 (prime) to 50 (subprime) basis points to oversee mortgage pools, plus float and fees
 - Servicers in the subprime sector are more heavily dependent on fees to cover costs
 - Expenses: current market environment significantly increases costs
 - Labor intensive process => increasing customer service may require increasing other parts of the process => customer service to REO management
 - The need to hire extra personnel and other costs may require 125 basis points to cover the cost of doing business in this market
 - For example: loan workouts cost \$1,000 per workout



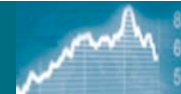
Economic Incentives

- Why has it taken servicers so long to respond?
 - Financial health of servicers
 - Advances all missed payments of the borrower
 - Repaid when loan is made current or when foreclosure is resolved
 - Servicers in the subprime sector are more dependent on fee income
 - Assisting with workouts cost servicers more money and reduces fee income



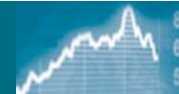
Modifications May Not Help

- A large percentage of modified loans will eventually default
 - Estimates ranging from 40% to 60%
- Other problems with modifying loans:
 - Investor may be worst off after a loan is modified
 - Class warfare => mortgages tend to be held in securitized pools where investors have different incentives based on where they are in the capital structure
 - Loss of excess spread
 - Release of O/C
 - Complicates how servicers should respond => increases risk of litigation
 - Quality of the home
 - Servicers may hold a ownership position in the pool



Accounting Rules

- FAS 140 allows the following:
 - Requires giving up control of the assets. Securitizing under FAS 140 transfers assets into a “special purpose entity”
 - Provides for regulatory capital relief for originators
 - These SPEs have to be “brain dead.” If they make business decisions (or if servicers make them on their behalf) it violates FAS 140 and the originating bank has to bring the assets back on balance sheet
 - Need for more regulatory capital
 - A modification is a business decision. Previously, rules were interpreted to mean that servicers could not modify loans unless they are in default
 - SEC clarification: loan restructurings or modifications when default is reasonably foreseeable does not preclude an institution from continuing to treat serviced mortgages as off-balance sheet exposures



New Perspectives

- What do we know?
 - Loan modifications as a percentage and share of loan workouts are increasing
 - Subprime loans: the majority of loss mitigation actions
 - Loan modifications are increasing at a faster pace than payment plans => significantly more payment plans
 - Subprime loans are more likely to enter into loss mitigation relative to foreclosure when compared to prime loans
 - The current housing environment is unusual and servicers are being forced to learn on the job
 - Challenges continue to outweigh successes
 - Some actions by servicers/lenders appear to be slowing down foreclosures
 - Interest rate cuts have helped reduce the number of borrowers needing assistance



Increased Usage Of Data

- Generate data at the community and neighborhood level
 - Markets can be very different within a county or MSA
 - Can lead to inappropriate solutions to resolve troubled loans
- Risk managers identify relevant pieces of information and use loss mitigation models to when formulating an appropriate loss mitigation strategy
 - Ex: inventory levels, the direction housing prices are moving, absorption rates, home price indices,...



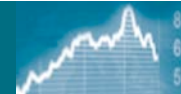
Aggressive Outreach

- Partnering with community-based and non-profit organizations to reach out to borrowers
 - Helps to increase response rate of borrowers
 - Letterhead
 - Contact borrowers
- Use risk models or risk metrics to identify borrowers that are potentially at risk before they get into trouble
 - Ex: Pre-emptive loan modifications



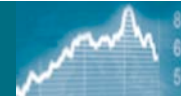
Sharing Data

- Sharing customer data among various groups that are trying to assist borrowers
 - For example: sharing data with non-profit credit counselors may help borrowers reduce unsecured debt
 - May improve borrower's cash flow => provides the servicer more options to help the borrower
- Sharing information on loss mitigation guidelines and strategies
 - For example: sharing information with outside mortgage counselors will to generate workout options that are consistent with the servicer's loss mitigation guidelines
 - Will reduce the amount of time that borrowers are delinquent and decrease the probability of foreclosure



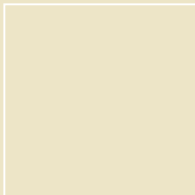
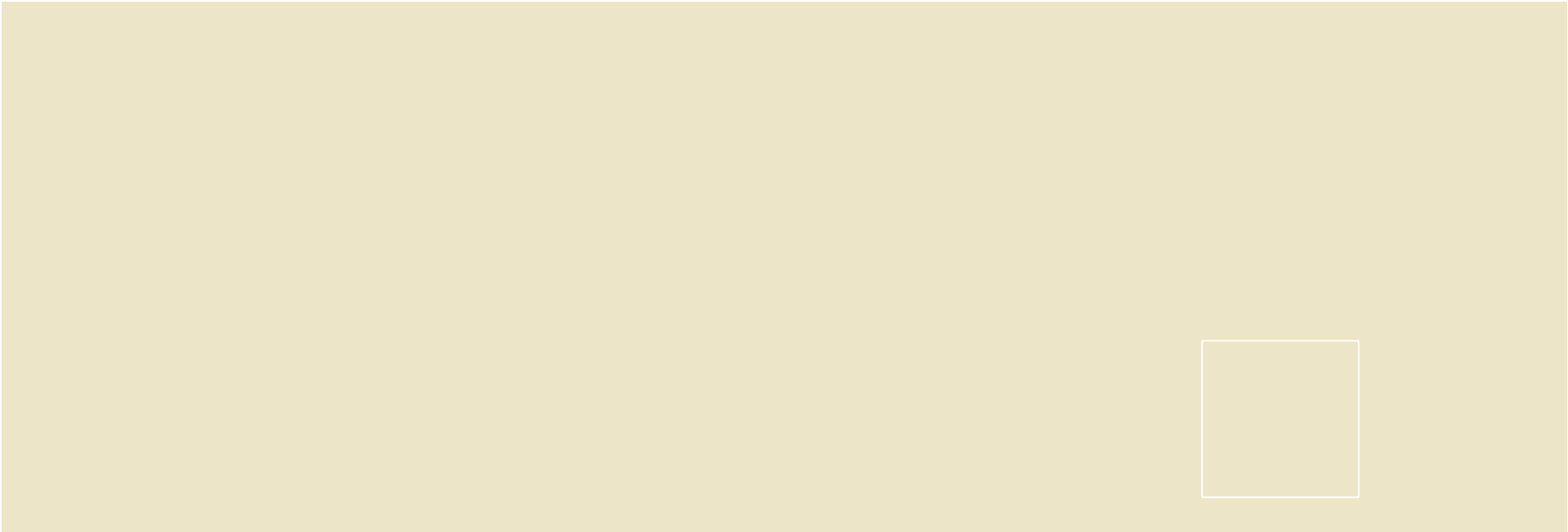
Servicing In-House

- The previous housing environment may have created an economic incentive for some lenders to use third party servicers
 - The current housing environment requires servicers to be flexible and focused
 - Servicers have to spend more time with each borrower
 - Fewer files increases the likelihood of a successful resolution => 150 files at a time
- Third-party servicing => is a volume business where representatives handle 500 to 1,000 files at a time.
 - Focus and flexibility to address the specific needs of your portfolio is not likely



Sell Loans

- Lenders can sell distressed loans by taking haircuts
 - Move poorly performing loans off the books
- Investors who purchase the distressed loans are now in a better position to work with borrowers to keep them in the home=> built in capital cushion
 - Lenders may be reluctant to take haircuts on loans and incur a capital expenditure when lenders are capital constrained on the balance sheet and external capital is expensive or in short supply



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Illustration of a Loan Modification

- Assume the following:
 - Unmodified 30-year loan on \$250,000 mortgage
 - Zero money down
 - Initial rate of 8% for 3 years, with interest rate of 12% for remainder of the term
 - Borrower defaults 6 months after reset. The house is sold 3 months later with 50% recovery rate
 - **Total NPV = \$61,343.19**

- Modified 30-year loan on same home
 - Servicer allows borrower to keep paying 8% after reset date
 - Borrower is able to make payments for nine more months before defaulting
 - House is sold by bank 3 months later with 50% recovery rate
 - **Total NPV = \$60,875.60**
- This example shows that modification can decrease NPV of cash flows