

Home Equity Lending – Servicing Comparing Mortgage Companies to Banks

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As lenders seek to maintain volume levels in the face of an overall decline in mortgage demand, home equity products represent a natural target to attain growth or, at minimum, replace the declines in the traditional mortgage market. While home equity lending in the past was traditionally the purview of banks, mortgage bankers and mortgage brokers are displaying aggressive moves to capture these volumes as niche products to replace traditional purchase money mortgages. The trend to sell the home equity product as a second lien loan/line simultaneously with a first mortgage as a means to avoid the private mortgage insurance requirements on higher loan to value loans continues as a primary offering of most institutions. In addition, the home equity product can be a conventional junior lien transaction or a senior lien as part of a refinance of the traditional first mortgage loan. Brokers continue to capture an increasing share of originations in both first and second products. The competition for business will remain intense and will provide servicing opportunities and challenges for both mortgage companies and banks.

This article explores the differing servicing components in the home equity asset between mortgage companies and banks. For the purposes of this article, mortgage companies are defined as institutions originating home equity loans or lines of credit and upon closing, sell the asset to an investor in the secondary market. The sale can be one of the receivable only, service retained, or the sale of the receivable and associated servicing rights, service released, to an investor. Many decisions such as size of the originations organization, income derived from service released premiums, investor requirements and the economic opportunities from maintaining servicing operations or anteing up the fee to a sub-servicer to provide servicing continues to drive the decision to sell service retained or released. Traditional banks are defined as institutions originating the home equity loan or line, holding these loans or lines in their portfolio, and servicing them for the full term.

The aspects of servicing covered in this article relate to servicing escrowed accounts for both tax and insurance requirements, access to home equity line of credit advances, payment and item processing, investor reporting and

clearing, interest revenue opportunities and risk.

Servicing Platforms

Both mortgage companies and banks face difficult decisions with respect to selecting the servicing system of record to host these assets. Traditional consumer systems typically host the home equity product at most banks with distinct mortgage platforms hosting the mortgage loans. Mortgage companies most often rely on their current mortgage system to service the home equity assets or, as mentioned, sell the servicing or assign it to sub-servicers.

As institutions desire to gain efficiencies or economies of scale from servicing real estate assets in general, they should look for technology solutions that represent an end-to-end solution for the entire process for multiple loan types as a means to gain efficiencies, reduce duplication of tasks and optimize the use of automated workflow solutions. In today's mortgage banking environment, the transfer of loans from the origination system to the servicing system can require significant re-keying of data and costly exception processes to capture data required for servicing that is not documented in the originations area. The lack of such an interface can be due to a situation where systems are not linked and the data does not migrate systematically from the loan origination system to the servicing system within the lender environment, or could result from the purchase of a loan from a broker or correspondent. Regardless, all lenders will continue to seek integrated solutions to reduce redundancies and ensure data quality from the onset of the servicing life cycle.

Servicing managers must attain continual improvements in servicing proficiency. These gains imply use of staff to perform like tasks for the range of real estate loans and avoid

duplication of tasks for "siloed" loan operations. In addition, servicing operations must avoid any channel conflict when duplicate loans to one customer reside on duplicate systems and potentially create inefficiencies that could negatively impact the customer experience.

Escrow Issues

Mortgage companies and banks differ greatly with respect to the escrow of taxes and insurance for a number of reasons. The traditional mortgage requires verification of tax payment status due to collateral risk perceptions and regulatory constraints. Insurance verification and tracking is considered an integral part of collateral maintenance for mortgage companies. Hence, mortgage companies and the investors purchasing the assets tend to follow traditional policies and requirements to escrow both tax and insurance as a means to track compliance. While escrow balances provide beneficial compensating balances to the servicer, the obligation adds considerable complexity to processes both at the time of boarding a new loan to the servicing system as well as during routine servicing of the loan. Mortgage companies that retain servicing must ensure appropriate set up of tax lines, verify full insurance for both hazard and flood, balance all impounds and set up elaborate tracking for subsequent procurement and payment of tax and insurance obligations. Additional business processes these servicers face involve exceptions and non-compliance to the escrow mandates. Situations such as force-placement of insurance can result in manual and labor intensive business processes to remedy the situation and limit the insurance risk. Tracking the collection of the forced-place premiums requires added expense. In addition, remedies to correct false-placement errors can bring about significant expense and carry additional risk. While escrow

management requires considerable infrastructure to support the activities, mortgage companies can leverage existing mortgage system functionality to support the escrow tasks.

Mortgage companies that release servicing or employ a sub-servicer perform a small number of tasks to ensure transmittal of the correct impounds to the servicer or to verify the initial insurance compliance. While some obligations may not be avoided by virtue of the sale representations and warranties, service released lenders avoid most responsibility for escrow servicing during the life of the loan.

Banks that portfolio their assets become responsible for establishing and maintaining escrow servicing. Escrow management for banks can be more challenging, as traditional consumer platforms do not have strong features to support escrow processes and may have limited support for workflow automation. For instance, fields such as those to track multiple tax jurisdictions and provide full-automated bill payment of taxes or multiple insurance renewals to the loan level may require manual ‘work-arounds.’ Banks should rethink the assumption that tax and insurance monitoring of the home equity lien in junior position is not necessary as the senior lien holder is performing those tasks.

Access to HELOC Advances

Currently, mortgage companies that retain servicing are at a disadvantage with respect to banks in the area of convenient and efficient access to HELOC advances. It is more difficult for these institutions to offer access to the borrower, as they must work through another provider for such features as access to an ATM network. The transactions require a partnership with a banking entity and may require additional time and expense to the servicer. Servicers that retain servicing would directly bear the added cost while those

releasing servicing rights pass the cost on to the eventual servicer.

Banks can leverage their legacy ATM networks already in place and provide convenient and efficient access to HELOC funds. This ease of access to the lines provides additional balance opportunities as well. An added advantage to banks is the potential fee income opportunity tied to the ATM access. Hence, banks have a considerable edge in this area of servicing.

Payments, Item Processing and Clearing

As with advance processing, mortgage companies that retain servicing must rely on a business partner or vendor to process or clear routine transactions. This reliance implies additional expense and a less advantageous cost structure. Mortgage companies have added expense for lock box and payment clearing services with no opportunity to garner income from these services.

The sale of the asset by mortgage companies results in other implications of control and cost to the home equity servicer. Investor guidelines dictate such issues as tolerances for payment processing, accommodating requests to change a due date or accepting payment extensions and a servicer loses flexibility and direct control of some decisions that affect the account. Investor reporting requirements represent added work to identify and report loan details to the investor. In the case of unique or custom reports, manual work requirements can add to servicing costs.

In the case of those mortgage companies that sell the servicing, the payment processing, item processing and investor reporting requirements are transferred to the ultimate servicer albeit wrapped in the sale as part of the sale of servicing premium.

Banks can leverage existing internal departments for payment and item processing and clearing to drive a more cost effective structure. Additional payments or items can serve to drive economies of scale when included with other bank transactions. Banks also maintain more control of the assets in the portfolio and adopt flexible policies when dealing with customer issues and account changes. Flexibility can be applied to such issues as payment tolerances or rolling due dates to work with customers to provide optimal terms for unique customer situations. Early efforts to accommodate borrowers can enhance future loss mitigation efforts.

Interest Revenue

The mortgage companies that sell the asset and servicing do so at the expense of any future income derived from both the stream of interest income and servicing fees. All income is derived at the time of sale and is limited to the spread between the note rate and the purchase rate. This tactic meets deliberate revenue goals for the organization at a point in time and insulates these institutions from any rise in servicing expense during the life of the loan.

Mortgage companies that sell the asset but retain servicing have the opportunity to receive income from servicing fee spreads but must be prepared to service the accounts profitably both today and in the future. This situation implies appropriate process, systems and scale to be able to do so. These lenders should be well poised to leverage existing servicing operations to minimize expense in servicing the home equity account.

Banks that portfolio home equity assets retain the revenue from the interest income stream but, as with mortgage companies, must service the asset profitably. In the case of banks, this profitability is measured by the cost of interest income net of cost of funds

and servicing costs. One advantage this portfolio configuration affords banks is maximum flexibility to establish the most advantageous interest accrual method, average daily balance versus actual daily balance, to maximize revenue opportunity. The composition of the home equity portfolio impacts the banks income opportunity as well. The variable rate portion of the portfolio will adjust upwards as market rates rise and provide some ability to meet current cost of funds expense. However, fixed rate products remain the product of choice for many borrowers and continue to represent a significant portion of most home equity portfolios. The fixed book of business will continue to put significant pressure on margins in a rising rate environment.

Risk

The management of the home equity portfolio must include a thoughtful, deliberate and complete risk management strategy. Servicing risk is divided into three general areas, credit, collateral and product risk. Credit risk is the traditional risk of borrower delinquency and the details that surround delinquency such as loss mitigation, bankruptcy, foreclosure and REO processes. Collateral risk can involve both issues of traditional loss of value due to underinsurance or lack of insurance for physical loss as well as declining home values in over inflated markets or where initial valuation was not accurate. Product servicing risk refers to the risk associated with servicing loans or lines with terms that adjust or change as market conditions change. These products include risk associated with increasing interest rates for adjustable rate lines of credit. ARM volume, fueled by unprecedented low interest rates is rising for both home equity products and first mortgages as consumers shift from traditional fixed rate mortgages to ARM products or other hybrid products. The combination of rising interest rates and

associated payment increases for both a first and second payment scenario can affect the repayment of both loans for borrowers, particularly those with more marginal credit or heavy debt loads.

Mortgage companies with service released strategies do not assume risk beyond the obligations in the sale representations and warranties. Risk is transferred along with the asset and the servicing rights.

Mortgage companies that retain servicing assume some operational, credit and collateral risk. While investors assume the ultimate performance risk, tasks necessary to contain risk result in added servicing expense.

All risk components remain with banks that portfolio home equity assets. Payment adjustment risk can exacerbate delinquency risk in rising rate markets. In some cases, situations where a default on the first mortgage occurs due to a borrower's inability to qualify for a balloon re-write or a conversion from adjustable to fixed rate loan could further affect the home equity performance.

Control of collateral risk requires more expensive due diligence within the servicing operation to monitor insurance and tax status. However, these activities alone cannot control added collateral risk from market forces. Homes in inflated pricing areas or any over valuation of the collateral from the origination side pose a significant threat if housing markets decline. Housing prices rise in tandem with favorable rate environments and could fall in tandem with an unfavorable rate scenario. Additional expense related to risk mitigation can include escalated delinquency collection cost, tax or insurance base advances and cost of force placement of insurance coverage for hazard or flood.

Summary

The home equity markets represent an arena where traditional lines between mortgage companies and commercial banks can be reviewed for opportunities to leverage common servicing functions. In addition, mortgage companies (direct mortgage lenders and mortgage brokers) are aggressively pursuing home equity business that has been predominantly served by commercial banks. This situation will begin to create some channel conflict within bank owned mortgage companies when the product sets compete. And with the market moving forward, banks and mortgage companies continue to chase home equity assets and servicing. The mortgage companies are more interested in home equity due to the shrinking of traditional mortgage volumes caused by interest rate pressures and recent refinancing.

Mortgage companies and banks are becoming more proficient at servicing home equity assets since the ultimate profitability of the home equity servicing business is largely dependent on utilizing the most efficient, effective environments for the least amount of cost. These efficiency gains will result from finding ways to leverage existing staff and processes that pertain to all real estate transactions regardless of whether it is the mortgage company or the bank. Scale will become a more important factor in justifying technology investments to minimize operational costs as servicing expenses rise. Technology companies will start to look at their products serving the full market as opposed to just bank consumer or mortgage company specific applications. In addition, servicing managers will look for technology solutions that better integrate originations and servicing for home equity lending including providing host functionality for multiple product sets and consolidated borrower information.

Advantages exist for mortgage companies that limit risk and expense by selling the asset and/or the servicing or leverage existing servicing operations. Banks capture additional revenue from servicing the assets but also

assume added risk. Based on the historical quality and revenue potential of the traditional home equity offering banks just might have the edge.

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