Evaluating servicing models in the face of industry headwinds

Building a better working world

Executive summary

Economic, regulatory and consumer pressures have compelled mortgage servicers to reconsider their operating models based on their portfolio. While subservicers can offer lower-cost servicing for some banks, the concession of control over risk management and customer experience must be considered for determining the right operating model.

Economic, regulatory and consumer pressures prompt mortgage servicers to reassess options (in-house, subserviced or hybrid).

- Mortgage servicers are re-examining their operating models for risk and reward trade-off.
- The three main operating models of in-house servicing, subservicing and hybrid servicing have profitability, risk and customer experience implications.
- Servicers must balance these implications with portfolio size growth outlook, investment appetite and core competency considerations.

Mortgage servicing is at a critical juncture

Rising costs with a potential recessionary market looming, increased regulatory scrutiny and regulatory enforcement actions are making it challenging for servicers to mitigate risk and increase transparency for customers and regulators alike. In addition, servicers need to keep up with changing customer expectations centered on trust – a crucial factor in building relationships that are more than just transactional.

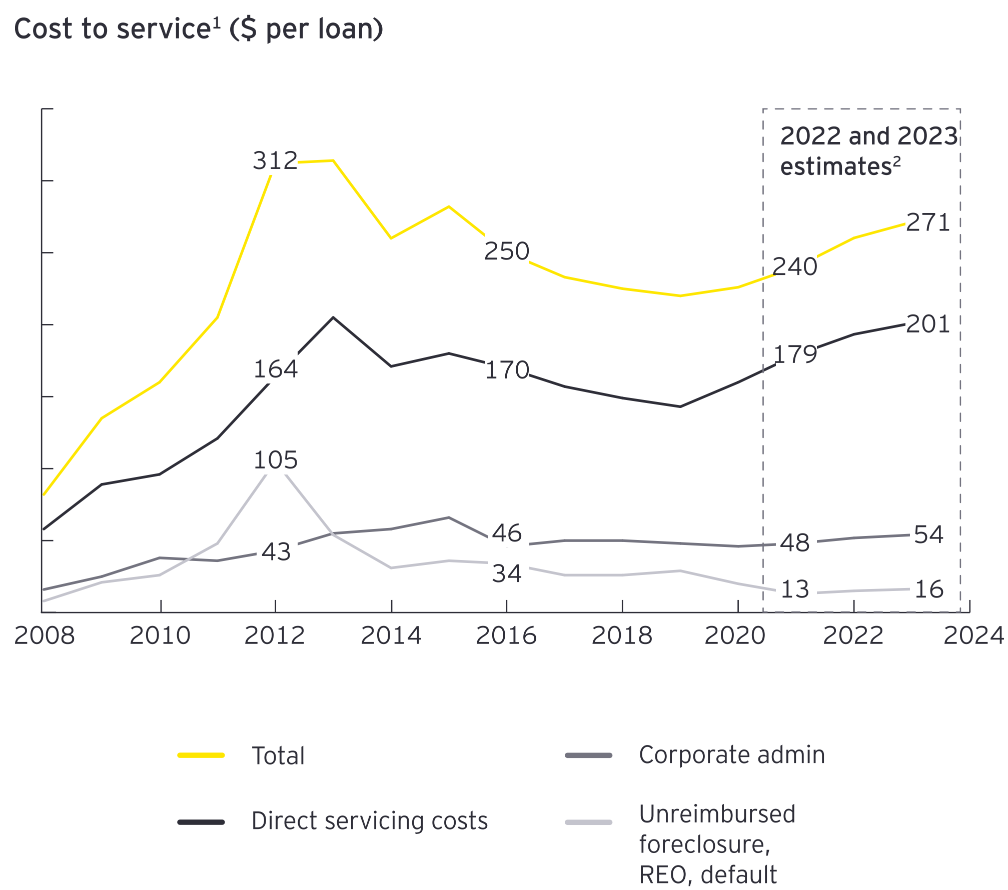

Figure 1. Inflationary pressures are challenging operational profitability, causing servicers to consider strategic alternatives and investigate how to reduce their cost bases to improve operational efficiency. [1] "Servicing Operations Study and Forum for Prime and Specialty Servicers," *MBA website*, https://www.mba.org/news-and-research/research-and-economics/single-family-research/servicing-operations-study-and-forum-for-prime-and-specialty-servicers, accessed November 17, 2022. [2] Estimate assumptions: 2022 and 2023 projected in line with assumed inflation (~8% and ~4%, respectively), unreimbursed foreclosure/real estate owned (REO)/default rising double the rate of inflation.

As such, servicers are working to ensure they have the right model and tools in place to respond to economic, regulatory and consumer pressures. Three primary operating models have prevailed across the landscape: in-house servicing, subservicing and hybrid or component servicing. Each model offers profitability, risk and consumer experience trade-offs that must be considered in this turbulent environment. When making this decision, servicers need to consider the preparedness of their organizations to adopt changes if a switch to a new model is sought. This includes aligning several organizational functions, from operations to technology to risk, compliance, finance, etc., so that all stakeholder groups understand the model being chosen, digest how they are impacted and implement changes to make the selected choice effective.

Trade-offs servicers need to address in model decisioning

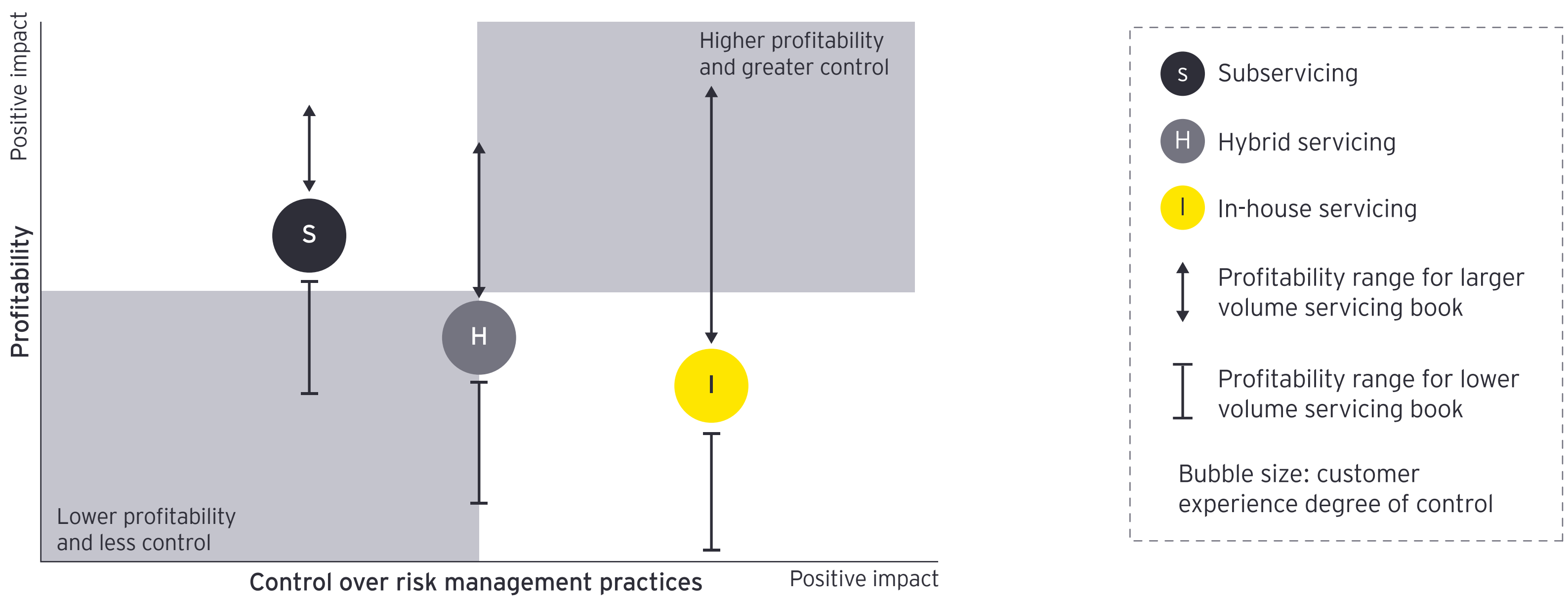

Figure 2. Servicers must consider their respective scale, book composition, risk tolerances and customer experience aspirations in selecting their optimal model. Servicers with large loan volumes can negotiate effective unit rates in a subserviced model but need to establish a robust oversight function — or leverage that scale in an insourced approach. Subserviced models are typically more profitable than in-house models for smaller servicers, given high capital requirements of standing up and maintaining servicing functions. Though the model bifurcates scale, hybrid servicing can be profitable for both large and small servicers — provided the lenders consider their competencies when choosing what to insource vs. outsource.

1 | In-house mortgage servicing model

With an in-house model, the servicer interacts directly with the borrowers, who are its customers. This gives servicers the ability to make necessary consumer experience adjustments and communicate in a speedier, more direct manner. In-house servicing also gives servicers more control over processes and allocation of resources, provides new cross-selling opportunities and naturally increases operational transparency. Done correctly, an in-house servicing model can also help drive a tailored experience that can boost primary financial relationships across a financial institution. With the degree of control enabled with an insourced model, firms can have purposeful engagement with their servicing customers and therefore enhance retention and their value propositions. This level of control can also allow servicers better transparency and oversight to key risk drivers and operational performance — although regulators have recently targeted in-house, outsourced and hybrid models alike. The downsides of in-house servicing can be the cost of technology and an increased cost to operate, especially at low volumes where proper scale cannot be achieved, including the need to recruit, train and retain a qualified loan servicing staff.

2 | Mortgage subservicing model

Conversely, for subservicing vendors, both the bank servicer and the borrowers are customers. With this model, the primary upside for the bank is profitability as subservicers can offer a significantly lower cost to service per loan, especially if the bank is unable to scale up its existing volumes. Subservicers leverage existing infrastructure shared across multiple clients to lower unit costs with ready-made pieces, eliminating the requirement to procure the correct technology, people, etc., to build a servicing operation from scratch. Although subservicers perform the day-to-day mechanics of servicing, this model does not cure the lender of the primary risk and responsibility of compliance, controls and issue remediation. This necessitates that lenders establish effective oversight models to ensure regulatory requirements and compliance controls are met throughout the servicing lifecycle. Poor oversight models can result in duplication of efforts, ineffective communication, incorrect staffing levels across functions and regulatory violations.

In addition, subservicers and their clients that do not correctly and consistently prioritize, triage and manage issues, and predict or prevent them from recurring run the risk of negatively impacting customers and running afoul of regulations. Reporting and management information systems are another key hurdle with this model. Although subservicers may use a variety of standard and add-on reporting functions, bank servicers must enable mechanisms to ingest canned reports and set up automated dashboards that can serve as a consolidated one-stop shop for all things oversight (e.g., key issues, complaints, escalations and regulatory exams), which would enable oversight functions and senior management to perform effective supervision. And while these obstacles, in addition to sacrificing personalization of the customer experience, are significant, cost considerations are prompting more and more organizations to select this servicing approach.

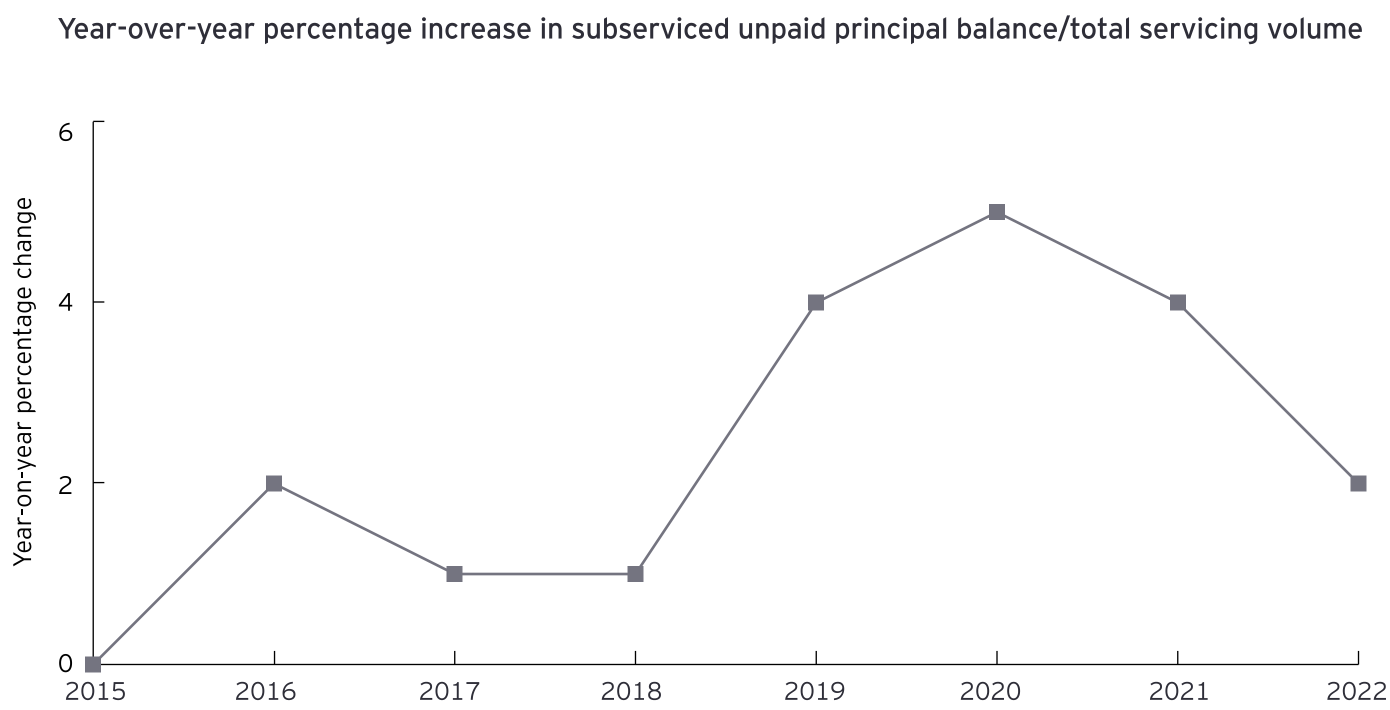

Figure 3. Subserviced unpaid principal balance has grown as a percentage of all serviced UPB by roughly 2% to 5% a year over the past decade. Source: EY benchmarks, bankdirector.com.

3 | Hybrid mortgage servicing model

The third option, the hybrid mortgage servicing model, enables firms to outsource specialty servicing areas that require particular skill sets, such as foreclosure. What this translates to is that bank servicers can choose loan types to service based on cost synergies, existing competencies and staff skill sets, and desired customer experiences — creating a best-of-breed mortgage servicing model between options one and two. But this approach comes with its own complexities in that users need to consider the impact of bifurcating scale and potentially missing out on cost advantages created by either a fully insourced or subserviced model. In addition, compliance and fair-lending guidelines must be taken into consideration across multiple servicing methodologies. The hybrid model requires creation of two risk and compliance oversight lenses — one for the subservicer(s) and another for loans serviced internally — and needs to be capable of digesting data from multiple sources for necessary reporting purposes. Hybrid servicers must also ensure they do not create dissimilar customer experiences that would be in violation of fair-lending requirements.

Where does the industry go next?

The mortgage servicing industry continues to evolve, influenced by cost pressures, increased regulatory scrutiny and changing customer expectations. Servicers are continuing to assess which mortgage servicing model is right for them based on the unique conditions in which they operate. Servicers must match their current operating model, infrastructure, risk tolerances and growth horizons to profitability, regulatory and consumer expectations to choose between the three dominant industry models.

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