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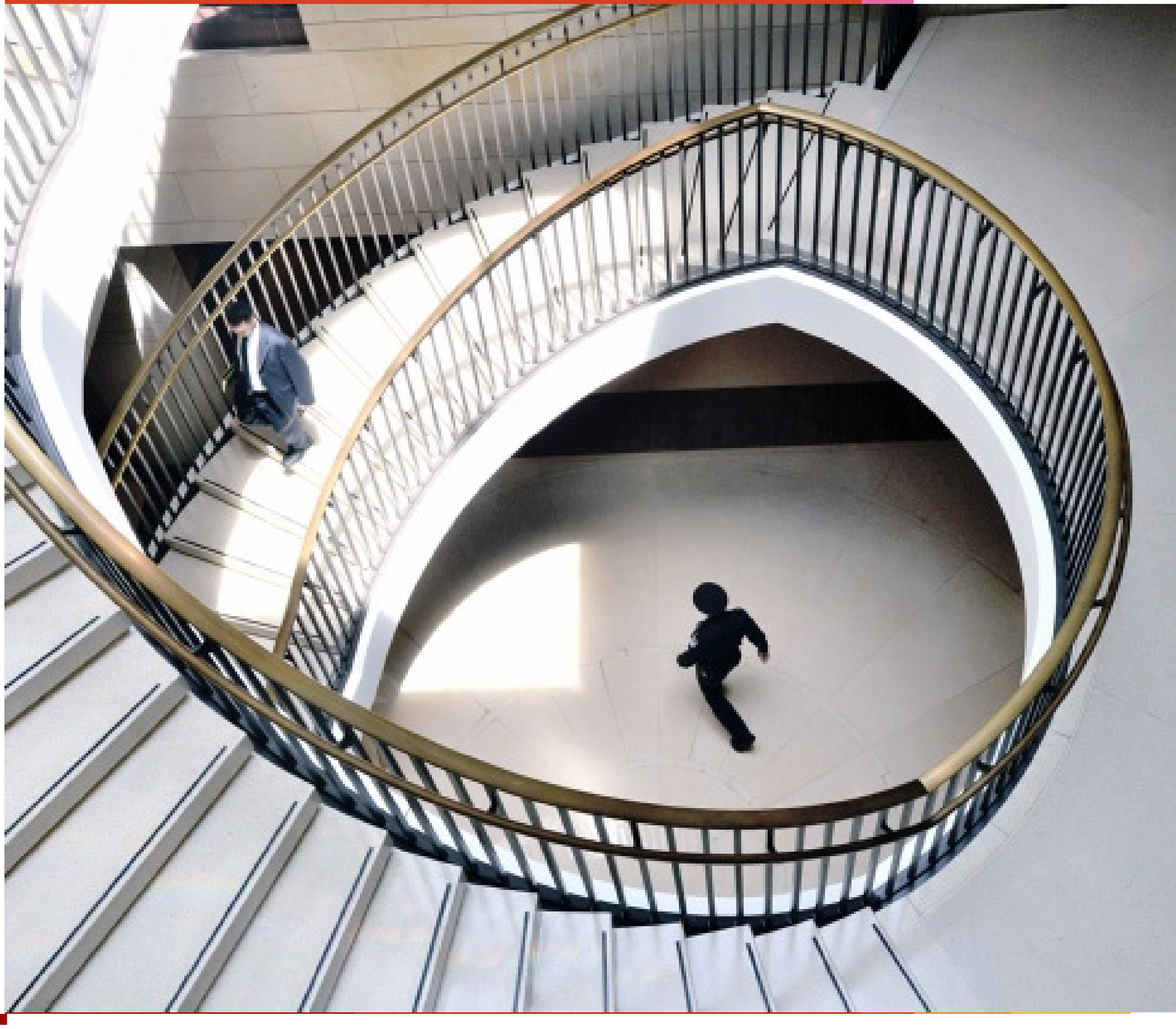
Mortgage servicing/ subservicing transfers

Understanding and managing the hidden operational challenges

February 2014



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Summary of our analysis

For a mortgage servicing transfer to be a success, the seller and buyer both should take into account the "hidden" challenges of the transfers.

The volume of mortgage servicing transfers in recent years has steadily increased as a result of numerous mortgage servicing right (MSR) sales and the use of subservicers. The impact of Basel III capital requirements and the new mortgage servicing rules are driving the increase, as well as other industry and market changes that have prompted large financial institutions and regional banks to rethink their mortgage servicing business model.

Parties involved in a servicing transfer are typically aware of the challenges that arise from the complexity of the transfer, including the impacts of portfolio size, product mix, investor mix, and delinquency. However, the organizations on both sides of the transfer are also subject to less obvious operational challenges that must be managed to enable both organizations to realize the intended benefits of the transfer.

Those "hidden" operational challenges include the following:

- Managing the impacts of the transfer on the customer experience (customer-facing transfer issues will affect the seller's and the buyer's reputations)[1]

- Getting sufficient availability of key personnel on both sides to dedicate time to the transfer in addition to continuing to perform their day-to-day responsibilities

- Obtaining investor and regulator consent

- Clearly identifying all product types that will be part of the transfer (large MSR sales may contain certain products that require unique servicing treatment, which could present challenges both to the retiring servicer and the new servicer)

- Managing the inventory of workouts/loss mitigation options being discussed with the borrower at the existing servicer and whether they are consistent with the alternatives being offered by the new one

- For subservicing, establishing a robust surveillance function and definition of service levels (limited oversight will create exposure for the primary servicer, while restrictive authority delegation and service levels may limit the subservicer's effectiveness)

- Also for subservicing, building general ledger interface/defining flow of data from the subservicer to the primary servicer

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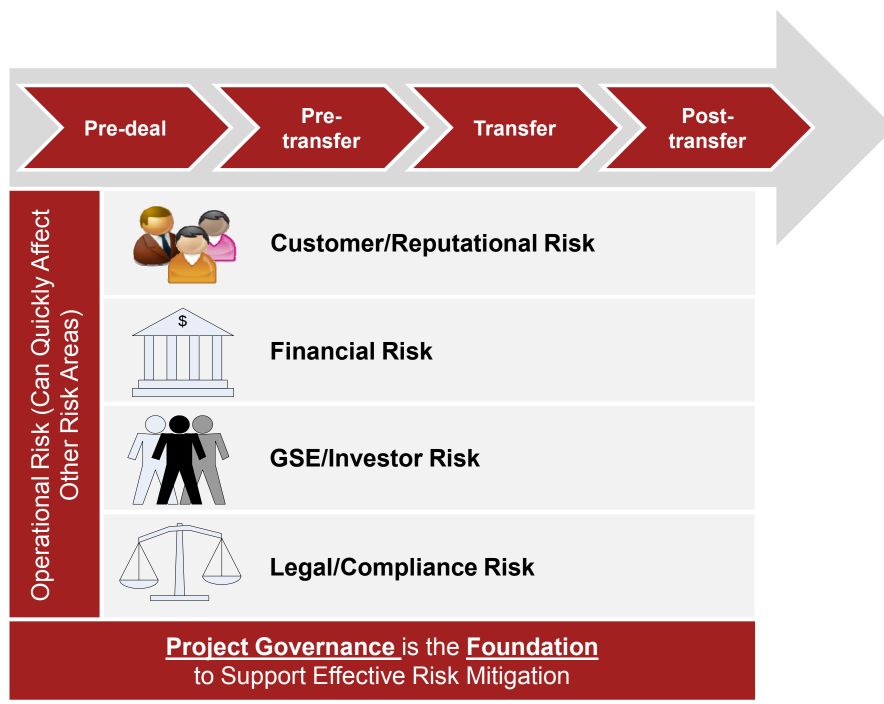
[1] For simplification purposes, we use the terms "buyer" and "seller" to reflect "transferee" and "transferor," respectively. We recognize that there may be situations where the transferor and transferee did not buy or sell the MSR asset.

These operational challenges arise across the life cycle of a mortgage servicing transaction (i.e., during the Pre-Deal, Pre-Transfer, Transfer, and Post-Transfer phases of the transaction), and they can expose one or both of the organizations to customer/reputational risk, financial risk, investor risk, and legal and compliance risk. For example, the Consumer Financial Protection Bureau has recently found that certain servicers had violated the notice provisions of the Real Estate Settlement Practices Act (RESPA) and had engaged in "unfair practices" when they mismanaged various aspects of mortgage servicing transfers (particularly in relation to loss mitigation).[2]

These hidden operational challenges can be best managed by a combination of (1) developing an appropriate governance process; (2) addressing potential hidden challenge during the purchase agreement negotiations or, in the case of subservicing transfers, during the contract negotiations; and (3) actively managing the potential hidden challenges within the particular phase in which they may arise.

There are different attributes of a servicing transfer governance process and the particular challenges that arise within each phase of a servicing transfer:



[2] See CFPB Supervisory Highlights for Summer 2013 and Winter 2013, both available at www.consumerfinance.gov.

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