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A Servicing System For Borrowers

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"Only 10 percent of borrowers feel a sense of loyalty toward their current primary home mortgage servicer, according to a study released today by customer satisfaction guru J.D. Power and Associates".[2]

I Introduction

Until now, servicing was done by lenders, <u>for</u> lenders. Servicing was about collecting payments at the lowest possible cost. You lost money by improving service to borrowers, unless you could do it without increasing costs.

Lenders have had no business reason to provide quality service. Borrowers can't fire their servicers, except by refinancing. The refinance decision, however -- whether to do it and who to do it with -- is rarely affected by borrowers' servicing experience. It is not surprising, therefore, that mortgage servicing has not met the needs of borrowers.

According to HUD, two of every five complaints alleging violations of the Real Estate Procedures Settlement Act involve servicing issues, as opposed to issues connected to settlement costs. [3] This is consistent with my own experience in fielding questions from borrowers, as noted below.

Even what might appear to be exceptions to this generalization, such as alerting borrowers to the possibility of a cost-reducing refinance, are not really. Lenders seek to identify borrowers for whom the probability of refinance is high, so they can cut them off at the pass. This is quite different from identifying those for whom the cost benefit is high. There is overlap, to be sure, but the difference in intent is clear.

But this is going to change. We will soon see the emergence of servicing systems for borrowers (henceforth, SSBs). This paper explains why and

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[2] Inman New, November 27, 2002.
[3] Reported by Lew Sichelman in National Mortgage News, September 6, 2001.

how. Section II describes the relationship between SSBs and existing servicing systems. Section III describes the services that will be offered by SSBs. Section IV describes some major features of SSB technology. Section V discusses how to make money out of it. Section VI considers who might deploy a SSB.

II SSBs as Second-Tier Servicers

The SSBs described here are not intended to replace existing servicing systems. The entities providing the services described below are second-tier servicers. Borrowers agree to make their payments to second-tier servicers, who make payments to the primary servicers.

With the payments going through its hands, the second-tier servicer has command of information on the borrower's payment history. When the borrower signs on, furthermore, the second-tier servicer acquires baseline information on loan, property and borrower characteristics. Other information may be provided by the borrower when the borrower accesses specific services.

First-tier servicers could offer the same services as second-tier servicers, and in time competitive pressures will force them to do it. But first-tier servicers won't be the innovators for reasons indicated above. Not only is there a lack of business purpose, but legacy servicing systems would be a major handicap. The second-tier servicer can use a system designed from scratch to accommodate the needs of borrowers.

III Services Provided

In 1998 I began writing a newspaper column on mortgages that invited questions from consumers. I have since had about 12,000 letters left on my web site, www.mtgprofessor.com, of which half or more are about servicing problems. The features of a SSB described below deal with the issues that arise most frequently. All the features are web-based.

Access to Payment History: The major purpose of this service is to provide peace of mind that the lender is properly crediting mortgage payments. I have learned that many borrowers, and especially those who make extra payments, are extremely anxious about this.

Their anxiety is sometimes justified. Many lenders provide only annual statements, extra payments are often not identified as such, and misuse occurs. Recently I received a letter from a borrower who discovered that for 15 years her lender had been accumulating extra payments in a special account, rather than applying it to principal. The lender told her that when the balance had been paid down to the amount in the account, the loan would be retired!

Earlier this year, I wrote a column on what borrowers could do to assure that they were getting proper credit for extra payments. In connection with this column, I developed an Excel spreadsheet that automatically adjusts the amortization schedule for extra payments. The column offered to send the spreadsheet to anyone who requested it. The response was staggering, far beyond my capacity to comply. I had to place the spreadsheet on my web site from where they could download it without my involvement.

Some of those who wrote me said, “why can’t I get this from our lender?” Why indeed.

The SSB would allow borrowers to monitor their accounts continuously. In addition, it would provide the same what-if functionality as my spreadsheet, allowing borrowers to experiment with different future payment patterns.

Access to Details of ARM Rate Adjustments: The major purpose is to provide peace of mind that the new rate has been properly calculated. This is a problem that generated a lot of attention some years ago, when it was variously estimated that 30% or so of the rate adjustments were wrong. It is nowhere near as bad as that now, but borrowers still worry about it.

The SSB would show the details of the ARM rate adjustment, rather than just the resulting new rate, which is what they get now. It would show the value of the rate index used in the adjustment, the arithmetic of the adjustment including any rounding, and whether the change was affected by caps. In addition, the data inputs used to calculate the new payment would be shown.

Borrowers would be able to access this function prior to the rate adjustment, indeed, at any time. For example, 3 months before a rate adjustment, they could determine what the new rate and new payment would be if the index value in 3 months is the same as it is now. This could be critically important in making a refinance decision.

Cost Reduction Refinance Opportunities: The purpose is to flag profitable refinance opportunities. The SSB would continually monitor the relationship between the borrower's interest rate, current market rates, and the borrower's credit as affected by his mortgage payment record. On ARMs with rate adjustments scheduled within the next (say) 4 months, refinance analysis would be based on the new rate forecasted at the adjustment.

Cash-Raising Opportunities: The purpose is to provide borrowers who request it with a tool for assessing alternative ways to raise cash. The system would already know many of the required data inputs, including the borrower's existing mortgage balance and terms, as well as current market terms. Other data inputs, such as the amount of cash needed, would be entered by the borrower.

Of course, servicing agents now are usually pleased to respond to inquiries from existing borrowers about new second mortgages or cash-out refinance options. However, they have no way to anticipate such requests, and their servicing provides no help to the borrower in identifying and assessing available options.

PMI Termination: The purpose is to give the borrower a "heads-up" that it may be possible to terminate mortgage insurance. This is a major concern to many borrowers because, despite the Federal legislation passed in 1999, termination at the earliest possible time requires that the borrower take the initiative.

The 1999 legislation requires lenders to terminate PMI automatically when the loan balance is paid down to 78% of original property value, based on the original amortization schedule. Additional payments to principal are not taken into account. If the borrower requests it, furthermore, lenders must terminate when the actual balance (taking account of extra payments) hits 80%. On loans sold to Fannie or Freddie, the termination threshold is based on current appraised value rather than original value, but once again the borrower must take the initiative.

In flagging a termination opportunity, the SSB would take account of extra payments, market appreciation, and other factors that affect eligibility including the borrower's payment record. Market appreciation would be estimated, based on valuation models that determine average appreciation for specific geographical areas.

Alternative Payment Options: The purpose is to allow borrowers to pay biweekly, bimonthly or weekly. Borrowers may prefer one of these options because they find the schedule more convenient, or because they want to pay off early.

Some servicing agents offer one or more such options, although they charge for it, but many do not. As a result, there is a bushel of third party players who offer biweeklies, for a setup fee of $250-400. The borrower pays the third party, who pays the lender. The third party enjoys a healthy float, since it takes a year before biweekly payments generate a fund large enough to permit a double monthly payment to the lender.

Home Equity Supplement Plans: An SSB vendor who offers home equity lines could market a plan designed to neutralize some of the hazards to borrowers arising out of the inflexibility of the standard mortgage. Under the plan, the home equity loan could be used only for the prescribed purposes.

For example, borrowers who skip a payment and then pay on time accumulate delinquencies until they make a double payment. With the special line, the borrower could avoid having to skip the payment in the first place by accessing the line. The line could also be used to permit borrowers to pay more in some months and less in others. And borrowers with excess cash looking to lower their payments could do it by paying down the home equity line. The monthly payment on a fixed-rate mortgage can't be reduced by making extra payments to principal.

This special line could be marketed as "the home equity loan designed to keep you out of trouble."

IV SSB Technology

The technology upon which a SSB is based can be visualized as an array of integrated and dynamic web-based calculators. These calculators would be very different from the stand-alone and static calculators that now populate the web. Some of the principal differences are:

1. With static calculators, the user must take the initiative to identify the problem or opportunity. With dynamic calculators, the system identifies the problem or opportunity and flags it for the user.

2. With static calculators, the user must find the calculator on the web that deals with his problem, from the large array of those that are out there. This is a major impediment to more widespread use. With dynamic calculators, the system that identified the problem, also provides the right tool for dealing with it.

3. With static calculators, the user must input all the information the calculator needs to answer the question, including current market information that they must get from shopping the market. This is also a major barrier, since most users want to do their research before they shop. With dynamic calculators, most of the information will be filled in by the system, including the current market information.

In effect, the SSB would provide every borrower with a set of unique calculators. They are unique in the sense that they are populated with data that is unique to that borrower, and that is constantly being updated.

V <u>Revenue Sources</u>

There are two potential sources of revenue for the entity providing a SSB. One is to charge borrowers a monthly fee for the service. I have in mind a charge on the order of $5 a month, perhaps $7 for ARMs, which have more formidable data input requirements. But there is no market research behind those numbers, and $.50 a month might work better because of the second source of revenue.

This is the sale of loans and other services to customers. A borrower who signs up with a SSB becomes a customer of the SSB in the most fundamental sense of that often misused term. Not only is there a continuous exchange of dollars for services, but the SSB is present each time the borrower makes a decision about a new loan. Depending on who the SSB is, the market terms that are deployed in the various calculators could be those of the SSB.

VI Concluding Comment: Who Might Deploy a SSB?

The ideal SSB-provider would have a name known to borrowers, because borrowers must be willing to trust the SSB with their payments. However, the fact that so many borrowers with biweeklies now entrust their payments to firms they had never heard of earlier suggests that this may not be a critical issue.

The ideal SSB-provider would be positioned to extract maximum value from acquiring new customers. A depository lender fills this bill, particularly as regards a home equity supplement plan. Of course, lenders who are first-tier servicers would be obliged to deliver the new service free to first-tier servicing clients, which could be costly.

Fannie and Freddie would have the advantage of name recognition, and have no servicing clients. They could use an SSB to get closer to consumers without lending to them. At the same time, they could direct loans to lenders of their choosing, which would extend their influence to segments of the market they now don't touch. They have the means and perhaps the motivation to give away the service, which would make it impossible for any other entity to compete.

But Fannie and Freddie probably would not do it if the private sector got there first.