

Servicing Costs and The Rise Of the Squeaky-Clean Loan

— by LAURIE GOODMAN —

The credit box is being squeezed by the fear of high servicing costs associated with loans likely to default.

Over the past few years, it has become much more difficult for a borrower to obtain a mortgage loan. The median credit score has risen from 701 in 2001 to 753 in 2015—and that’s just one telling indicator. ¶ The Urban Institute’s new Housing Finance Policy Center Credit Availability Index (HCAI), which tracks the percent of mortgages expected to go 90 days delinquent, now stands at 5.0 percent as of the third quarter of 2015—down from 16.4 percent in 2006 and 12.5 percent in 2001–2003. ¶ The credit box established by government-sponsored enterprises (GSEs) Fannie Mae and Freddie Mac and the Federal Housing Administration (FHA) is quite wide. ¶ So why is it so much harder to get a loan?

Because lenders have been applying credit overlays within these credit boxes for many reasons, including, most significantly:

- Uncertainty over when and why the GSEs or FHA will put the credit risk of a loan back to a lender for a violation of their underwriting or servicing rules; (for more information on how this is tightening credit and what policymakers can—and can't—do to address the challenge, see Jim Parrott and Mark Zandi's September 2013 paper, *Opening the Credit Box*, at www.urban.org/research/publication/opening-credit-box);
- heightened litigation and related reputational risk; and
- the high and variable cost of servicing delinquent loans.

The first two factors have been much discussed, by us and others, but the third factor—the focus of this article—has been largely overlooked.

How do the costs of servicing delinquent loans contribute to credit overlays?

It is expensive to service delinquent loans. In 2013, the cost of servicing a non-performing loan was, on average, 12 times that of servicing a performing loan—\$1,949 per year versus \$158 per year (see Figure 1).

The costs of servicing performing loans include both overhead and direct costs (servicing technology, escrow, call center, Web page maintenance, investor reporting, etc.). The costs of servicing non-performing loans include base costs of servicing any loan, the costs associated with managing a default (collection, loss mitigation, foreclosure, bankruptcy, etc.), as well as unreimbursed foreclosure and real estate-owned (REO) losses.

And while the cost of servicing all loans has risen recently,

the costs of servicing non-performing loans has risen much faster than that of performing loans. From 2008 to 2014, the costs of servicing performing loans increased 268 percent compared with 404 percent for non-performing loans. Because of this spike in cost, non-performing loans absorb a disproportionate amount of a typical lender's servicing resources despite being a small percent of the total holdings.

The Mortgage Bankers Association (MBA) third-quarter 2015 *National Delinquency Survey*, released in November, shows that 3.6 percent of the loans were non-performing (defined as 90 or more days delinquent or in foreclosure). That is, if the lender had 1,000 loans, on average, 36 of them would be non-performing. Total annual servicing costs for these loans would be \$70,164 (\$1,949 x 36). Total servicing costs for the 964 performing loans would be \$144,414 (\$158 x 933). Thus, in this instance, those 3.6 percent of non-performing loans would take up 32 percent or almost one-third of the servicing resources.

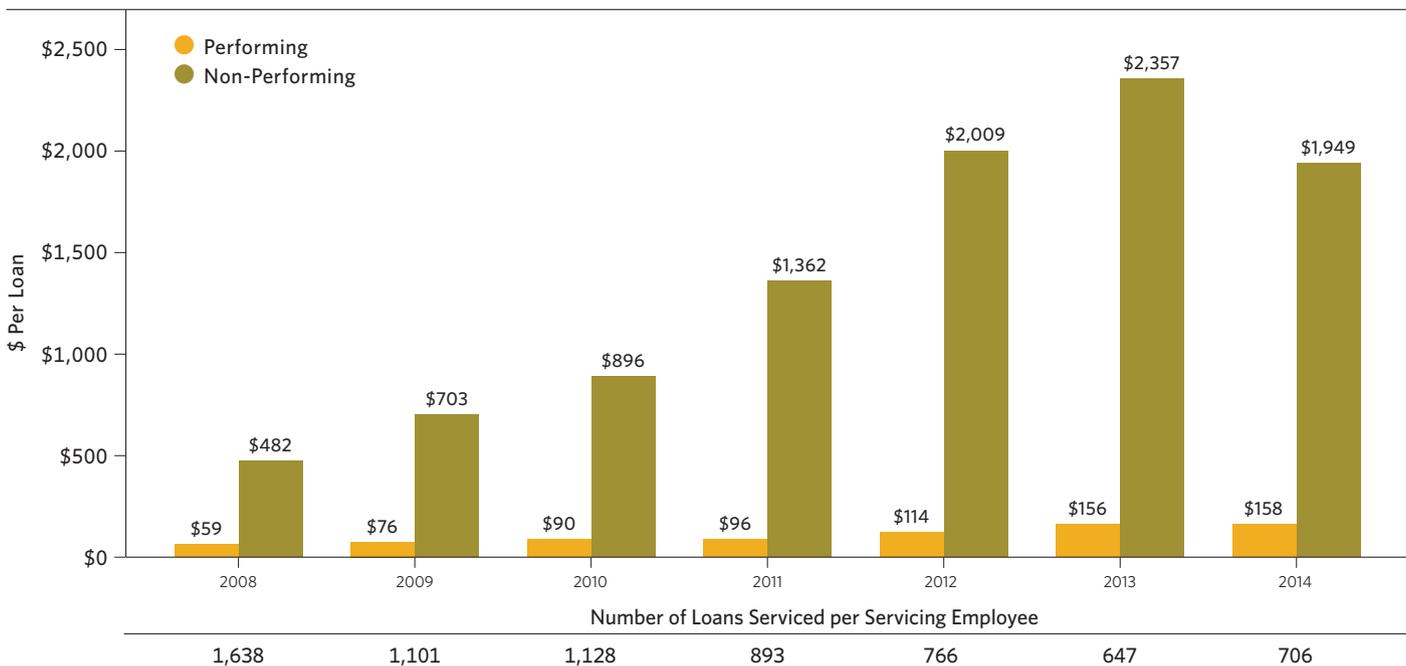
The labor-intensive nature of servicing non-performing loans is best illustrated by the number of loans a single employee can service (see bottom of Figure 1). This has fallen from 1,638 in 2008 to 706 in 2014.

These additional servicing costs could be added to the pricing of new loans at origination, and they often are. So if the probability of going delinquent is higher for higher-risk borrowers, these borrowers would pay a higher rate.

Similarly, if the costs of servicing a delinquent loan are higher in judicial foreclosure states with long timelines, some originators will charge still higher mortgage rates in these states. The economics of this are reflected in the market for mortgage servicing rights (MSRs): MSRs tend to have the

FIGURE 1

MBA SERVICING COSTS PER LOAN: PERFORMING VS. NON-PERFORMING



SOURCE: Mortgage Bankers Association (MBA) and Urban Institute calculations

lowest value when the borrower is higher-risk and the property is located in a long-timeline judicial state.

More critically, many loans will not get made because lenders are applying credit overlays. Many lender/servicers believe they cannot price for uncertainty related to the foreclosure process, pushing them to apply overlays in their underwriting requirements to protect against risk. These uncertainties include long and unpredictable timelines as well as increased concern about servicing transfers. The approval process for servicing transfers was once automatic, but is now more uncertain. This makes lenders more reluctant to make loans that have more than a trivial probability of defaulting, as lenders are less sure the servicing could be transferred if their strategy or risk tolerance changed.

Moreover, servicers are also unsure about the trajectory of servicing costs going forward. Faced with a wave of unanticipated delinquencies coming out of the crisis, servicers built systems quickly and inflexibly, and relied on untrained personnel. These inflexible systems contributed to perceptions of sloppy servicing, which in turn generated an ever-evolving set of servicing standards, requiring servicers to adapt their systems and enhance personnel training.

While these consumer protections were a necessary addition to the servicing landscape, the open-endedness of their development has increased the uncertainty around future servicing costs.

Longer foreclosure timelines

Average foreclosure timelines, or the length of time between the first missed payment on a loan to its liquidation, have increased as well—particularly in judicial foreclosure states, where a court order is required to evict a borrower. However, the costs quoted earlier in this article were annual costs. Thus, if it takes three years to go to REO, the cost is considerably higher than if it took two years.

FHA data shows that from December 2012 to September 2015, the average number of months delinquent at the time of REO liquidation has increased from 27 months to 38 months.

Freddie Mac data shows that fixed-rate, fully documented mortgages that liquidated in 2008 were, on average, 14 months delinquent at liquidation; in 2015, the average mortgage was 33 months delinquent by the time of liquidation.

This dramatic extension reflects the fact that more and more loans left in the pipeline are loans in judicial states (as the non-judicial states have cleared their pipelines), and the timelines in those states are extending rapidly. Moreover, these timelines are for the loans that have actually liquidated—many of the hardest-to-liquidate loans are still in the foreclosure pipeline.

Beyond the judicial/non-judicial distinction, each state has its own unique foreclosure rules, and every servicer must comply with the rules of each state. And while significant cost savings could be achieved by a uniform national set of foreclosure laws, this is politically infeasible in the current environment.

An additional challenge raised by these protracted timelines, in part regulatory driven, is that servicers feel caught between

two different mandates. On the one hand, states and the Consumer Financial Protection Bureau (CFPB) have established consumer protections that help ensure that borrowers have an opportunity to try to stay in their homes. On the other hand, both the Federal Housing Finance Agency (FHFA) and FHA impose fees on loans that take too long to get through the foreclosure process.

Often these two goals are in tension, if not outright conflict. While there is an appeals process, a failure to comply with GSE or FHA timelines must be resolved on a loan-by-loan basis with uncertain outcomes.

Promising movement by the GSEs

The FHFA and the GSEs require servicers to pay compensatory fees if the servicer's timeline to foreclose exceeds the "allowable delays" timeline published by the GSEs. Prior to November 2014, the timelines were so tight that two in three loans in the foreclosure process at the time would be flagged as being over the al-

lowable limit, according to MBA's Mortgage Action Alliance (MAA) issue discussion (see www.mba.org/issues/residential-issues/gse-compensatory-fees).

While the servicer is not responsible for "uncontrollable delays," once a loan is flagged, the servicer must establish the extent of such "uncontrollable delays" on a loan-by-loan basis—a cumbersome process.

Compensatory fees are calculated to compensate the GSEs for the foregone interest on the loan as well as the carrying costs on the property, including taxes, insurance, property preservation costs and homeowner association dues (if applicable) for each day over the timeline that was not deemed "uncontrollable."

The fee is determined as follows: the pass-through rate on the note, divided by 360, multiplied by the number of days delayed, multiplied by the unpaid principal balance on the loan. Thus, if a \$200,000 loan with a 4 percent note rate were 180 days over the limit, the servicer must pay the GSEs a compensatory fee of \$4,000.

On Nov. 17, 2014, FHFA and the GSEs announced their first set of servicing changes:

- The timelines in 47 states were lengthened. By lengthening the timeline, fewer loans will be flagged as taking too long and the fees for exceeding the timeline will be lower, as they will exceed it by less.
- Fees were temporarily suspended in areas where there have been too few liquidations to set a timeline for loans in the pipeline (i.e., Massachusetts, New Jersey, New York, and Washington, D.C). When the GSEs are comfortable they will set a time frame, update the allowable foreclosure timelines and retroactively apply the new timelines to foreclosures. Thus, the servicer will be billed in arrears for compensatory fees on these loans. The suspension of fees in states with insufficient information is an explicit acknowledgement that the original timeline was flawed, at least in part because it measured only liquidated loans, ignoring the most difficult loans—those that had not yet been liquidated.
- Fewer servicers are subject to compensatory fees. Most

The approval process for servicing transfers was once automatic, but is now more uncertain.

significantly, after Jan. 1, 2015, servicers will not be billed if total compensatory fees for the month are under \$25,000. The previous minimum was \$1,000. As a result, close to half of current servicers do not have to pay compensatory fees at all, according to MBA's Mortgage Action Alliance issue discussion.

On Sept. 3, 2015, the GSEs further extended the timelines in 33 states. The new timelines (see Figure 2) are considerably longer than the pre-November 2014 timelines, by from 60 to 690 days. The temporary suspension of the assessment of compensatory fees remains in effect in New York, New Jersey, Massachusetts and Washington, D.C., and will be re-evaluated in early 2016.

On Dec. 16, 2015, the GSEs released their framework for grading servicing violations. This went into effect on Jan. 1, 2016, so it is too new to see the effect. Prior to this, there were no rules as to when a servicing error could trigger a repurchase

request, creating a significant amount of uncertainty for lenders.

For example, if a lender did an improper modification and the loan defaulted, the remedy could be a repurchase. FHFA and the GSEs have now created a set of remedies other than repurchase for these types of servicing errors, which will be very helpful in limiting the uncertainty associated with servicing loans that have a higher probability of going delinquent.

A higher hill to climb at FHA

MBA estimates that the non-reimbursable costs and direct expenses associated with FHA's foreclosure and conveyance policies were two to five times higher than for GSE loans, even before the GSEs changed their compensatory fee schedule.

As is the case for all forms of lending, lenders make FHA

FIGURE 2

GOVERNMENT-SPONSORED ENTERPRISE (GSE) FORECLOSURE TIMELINE CHANGES (NUMBER OF DAYS)

State/City	Prior to 11/1/2014	New (9/3/2015)	Increase	State/City	Prior to 11/1/2014	New (9/3/2015)	Increase
Alabama	240	360	120	North Carolina	330	450	120
Alaska	300	480	180	North Dakota	405	630	225
Arizona	300	360	60	Nebraska	330	420	90
Arkansas	280	510	230	Nevada	390	900	510
California	330	540	210	New Hampshire	270	510	240
Colorado	360	540	180	New Jersey*	750	750	N/A
Connecticut	690	810	220	New Mexico	480	930	450
Delaware	480	960	480	New York City*	990	990	N/A
District of Columbia*	300	300	N/A	New York*	820	820	N/A
Florida	660	930	270	Ohio	450	570	120
Georgia	270	360	90	Oklahoma	420	600	180
Hawaii	530	1,080	550	Oregon	390	1,080	690
Idaho	440	570	130	Pennsylvania	600	810	210
Illinois	480	690	210	Puerto Rico	720	810	90
Indiana	480	570	90	Rhode Island	420	840	420
Iowa	450	630	180	South Carolina	420	600	180
Kansas	330	480	150	South Dakota	360	600	240
Kentucky	420	600	180	Tennessee	270	360	90
Louisiana	390	540	150	Texas	270	420	150
Maine	570	990	420	Utah	330	540	110
Maryland	485	720	235	Virgin Islands	510	510	0
Massachusetts*	440	440	N/A	Virginia	270	390	129
Michigan	270	330	60	Vermont	510	900	390
Minnesota	270	390	120	Washington	360	720	360
Mississippi	270	330	60	Wisconsin	450	540	90
Missouri	240	330	90	West Virginia	290	390	100
Montana	360	450	90	Wyoming	270	360	90

*Areas in which fees are suspended, pending recalibration

SOURCE: Fannie Mae

loans because they are profitable. Loans that go delinquent reduce and at times wipe out that profit margin, so lenders impose overlays to minimize the number of such loans they will have to manage.

There are several factors driving this much higher cost, each of which should be addressed by FHA:

- Foreclosure timelines in tension or direct conflict with CFPB servicing requirements;
- Large penalties associated with failure to meet these timelines;
- Vague standards for conveyance; and
- Insufficient allowances for property preservation.

Timeline issues

Since 1998, FHA servicers have been required to initiate foreclosure actions within 180 days of default. Missing this “first legal action date” results in the curtailment of debenture interest until the property is conveyed to the Department of Housing and Urban Development (HUD).

This penalty is applied whether a servicer misses the first legal action date by one day or by one year. For example, assume a loan misses the first legal action date by a day. If the remaining balance of the loan at the time of default is \$150,000, the debenture rate is 2.5 percent and it takes two years to convey the property to HUD, the lender would owe approximately \$7,500 ($\$150,000 \times 0.025 \times 2$)—a staggering 5 percent of the value of the loan.

It is critical to realize that once this first legal action date is missed, there is no way to make it up. And because the interest curtailment continues until the property is finally conveyed, it is far more expensive to miss the deadline in a long-timeline judicial state than in a short-timeline non-judicial state.

There are also situations in which this first legal action date is in conflict with CFPB rules. That is, under Reg X, the CFPB does not allow the initiation of any foreclosure process until the borrower is more than 120 days delinquent. If the borrower submits the loss-mitigation application near the end of that period, the application is denied, and there is an appeal that is also denied, then the servicer is likely to miss the first legal action date.

Moreover, if the servicer is in discussion with the borrower on day 120 and the borrower does not have the application in, most servicers believe it would not be appropriate to begin foreclosure proceedings. Not doing so, however, makes it more likely the servicer will miss its first legal deadline. In this situation, there is an appeal process through HUD’s Extensions and Variances Automated Requests System (EVARS). However, this process is cumbersome and inconsistent.

In addition to the first legal action date, servicers are required to manage the process from the first legal action date to the foreclosure sale date according to diligence timelines for each stage, which FHA has established on a state-by-state basis.

The GSE and Department of Veterans Affairs (VA) foreclosure processes also have timelines but they are not broken down

by stage, allowing lenders to make up time lost during certain overly long stages without being penalized, so long as the overall timeline is maintained. FHA allows no such flexibility, so lenders incur penalties even if the overall timeline is met.

As MBA has pointed out, the overwhelming majority of loans violate at least one of the two pre-set time frames. (MBA, in a July 30, 2014, letter from Pete Mills and Raghu Kakumanu to Kathleen Zadareky, deputy assistant secretary for single-family housing at HUD, noted that, “according to CoreLogic data, over 60 percent of all FHA foreclosures completed between 2011 and 2013 missed the deadline for first legal action and an additional 23 percent met the first legal action date but failed to meet the due diligence time frame.”)

While there is an appeal process, the appeals are on a loan-by-loan basis, rendering the process slow and the outcome uncertain. A process that assesses fees on the overwhelming majority of loans that default simply makes lenders less willing to underwrite loans with any chance of defaulting.

Moving to a single reasonable FHA foreclosure timeline that is consistent with CFPB regulations would be a major step toward reducing the costs of servicing delinquent FHA loans.

Property preservation and conveyance issues

The GSEs and the VA require servicers to convey title to properties within 24 hours of foreclosure sale or redemption. In contrast, the FHA requires servicers to convey the property within 30 days of a foreclosure sale or the receipt of marketable title, and to complete repairs

prior to conveyance to ensure the property is in “conveyable condition.”

This difference arises because FHA insures the loan, so it is technically owned by the lender. Only the owner of the mortgage (the lender) can foreclose. By contrast, the GSEs own the loans and they can direct the lender to foreclose.

Thus, with FHA, the lender absorbs some of the uncertainties of the foreclosure process, with strict limits on reimbursements. FHA also holds the servicer responsible for maintaining the property until the insurance claim is paid by HUD, rather than when title is conveyed.

This set of requirements presents several issues.

First, the definition of conveyable condition is unclear. FHA guidelines require that hazardous material be addressed, and the property be “broom swept.” However, the standards are often interpreted to mean “marketable condition,” which usually requires a good deal more work on foreclosed properties. This confusion can lead to reconveyances back to the lender, which are especially costly to lenders.

Second, at the point of foreclosure sale, the home may be occupied yet it must be conveyed vacant to FHA. In addition to concerns about missing timelines, forced evictions often result in increased damage to the property, exceeding the FHA allowances discussed next.

Making this even more of an issue, FHA covers borrower relocation costs up to \$3,000. In contrast, the GSEs have

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more flexibility; while they also generally provide borrower relocation assistance up to \$3,000, in order to encourage deeds in lieu of foreclosure in eight states with long foreclosure timelines (Connecticut, Illinois, Maryland, Massachusetts, New Jersey, New York, Pennsylvania and Washington, D.C.), the GSEs will pay a supplemental borrower incentive of up to \$7,000, bringing total borrower relocation assistance as high as \$10,000.

Third, the FHA allowance for repairs of \$2,500 is too small to allow many aging homes to achieve conveyable condition. Keeping within the limit is made even more difficult by line item caps for individual types of repairs.

Thus, even if the home only needs a roof repair and the total is within the total allowance, the roof repair may exceed the line allowance. While servicers can file for a request to go over the limit, the negotiation process is loan-by-loan—again, time-consuming and uncertain. In rare circumstances, it can cost so much to bring some homes, particularly lower-priced properties, into conveyable condition that the servicer will take the loan into its own real estate-owned portfolio and will not even bother to submit an FHA claim.

Fourth, during the time between conveyance and final payment, the property can be subject to both continued deterioration and vandalism. This increases the servicer's costs as well as liability, and the extent of that increase is not under the control of the servicer.

All these issues make servicing delinquent FHA loans tremendously costly. This in turn puts pressure on lenders to minimize the risk on the loans they make—i.e., to apply credit overlays.

The broader implications

The current credit box is too tight. This is the result of heightened and uncertain put-back and litigation risk, both of which have been much discussed. But it is also being driven by the heightened and uncertain cost of servicing delinquent loans.

While lenders can price loans for the costs of newly implemented consumer protections, the penalties resulting from not meeting the GSE and FHA timelines (including appeal processes), along with restrictive and anachronistic limits on reasonable expenses of foreclosure, create uncertainties that are difficult to price for, leading lenders to forgo lending to borrowers more likely to go delinquent.

The FHFA has made great strides with its 2014 and 2015 changes on compensatory fees and the new servicing remedies framework. It is likely the latter will need more refinement, as it is difficult to get it perfect the first time. Servicing delinquent FHA loans presents an even greater challenge, reflecting both rigid and unrealistic timelines and cost limits, and inflexible but uncertain conveyance and property preservation requirements.

The bottom line: To broaden access to credit, servicing issues are important and must be addressed. It's time to give them as much attention as we've given reps and warrants. **MB**

Laurie Goodman is director of the Housing Finance Policy Center at the Urban Institute in Washington, D.C. She can be reached at lgoodman@urban.org. Note: To sign up for the Housing Finance Policy Center's bimonthly newsletter, email spardo@urban.org.

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