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Options for Reforming the Mortgage Servicing Compensation Model

Karan Kaul, Laurie Goodman, Alanna McCargo, and Todd Hill-Jones

April 2019

The Mortgage Servicing Collaborative (MSC) is an initiative led by the Urban Institute's Housing Finance Policy Center that brings together lenders, servicers, consumer groups, civil rights leaders, researchers, and policymakers who appreciate the impact of servicing on the health of the housing finance system. By calling on a broad range of perspectives and expertise, the MSC has worked toward a well-grounded view of the policy challenges in servicing and a thoughtful, data-driven approach to addressing them.

Since its inception in early 2017, the MSC has published four policy research briefs with specific recommendations to improve the functioning of the servicing market for consumers and the industry. The first framing brief explained the high-level importance of servicing and outlined key issues in need of reform (Goodman, McCargo, et al. 2018). The second brief recommended enhancements to the loan modification toolkit for government-insured loans in a rising-rate environment (Goodman, Kaul, et al. 2018). The third brief proposed critical improvements to the foreclosure and conveyance processes for mortgages insured by the Federal Housing Administration (FHA) to achieve better outcomes for borrowers, reduce costs for servicers, and cut loss severities for the FHA (Kaul et al. 2018a). The fourth brief focused on the need for uniform mortgage servicing data standards and explained how standards can improve customer service, reduce costs, and lay the groundwork for future innovation (Kaul et al. 2018b). In this final research brief, we turn to the fundamental question of how servicing compensation, especially for nonperforming loans (NPLs), could be structured going forward.

About the Mortgage Servicing Collaborative

The Housing Finance Policy Center's Mortgage Servicing Collaborative is a research initiative that seeks to identify and build momentum for servicing reforms that make the housing market more equitable and efficient.

One core MSC objective is to improve awareness of the role and importance of mortgage servicing in the housing finance system. Since 2013, the Housing Finance Policy Center's researchers have studied the landscape, followed the work and policies put in place after the crisis, and assessed the impact of the servicing industry on consumers and communities. This includes loss mitigation and foreclosure actions and how servicing practices affect access to credit through tight underwriting standards. The Urban Institute has analyzed and convened forums on emerging issues in mortgage servicing, including calls for reforms, the impact of mortgage regulation, the rise of nonbank servicers, and the implications for consumers and communities. We determined that a focused effort that involves external stakeholders and resources could lead the way in developing policy and structural recommendations and bring visibility to the important issues that lie ahead.

The MSC has convened key industry stakeholders—including lenders, servicers, consumer groups, civil rights organizations, academics, and regulators—to develop an evidence-based understanding of important factors and to develop and analyze solutions and implications with a well-rounded and actionable orientation.

The MSC seeks to:

- bring new evidence, data, and recommendations to the forefront;
- foster debate and analysis on issues from regulatory reform, technology innovations, cost containment, and consumer access to mortgages; and
- produce and disseminate our research findings and policy recommendations—including perspectives by MSC members—to offer policy options that can clarify and advance the debate and ensure servicing is addressed in broader housing finance reform.

For more information about the MSC or to see other publications, news, and products, visit the MSC program page, https://www.urban.org/policy-centers/housing-finance-policy-center/projects/mortgage-servicing-collaborative.

Mortgage Servicing Collaborative Participants

- AmeriFirst: Mark Jones and Greg Warner
- Bank of America: Terry Laughlin and Larry Washington
- Bayview: Rich O'Brien and Julio Aldecocea
- Black Knight Financial Services: Joseph Nackashi
- Caliber Home Loans: Tricia Black, Marion McDougall, and Lori Foster
- Colonial Savings: David Motley and Jane Larkin
- Genworth: Steve Hall and Carol Bouchner
- Guild Mortgage Company: David Battany
- Housing Policy Council and Hope Now: Paul Leonard, Meg Burns, and Eric Selk
- JPMorgan Chase: David Beck, Ramon Gomez, Erik Schmitt, and Diane Kort
- Katie Porter: Faculty at University of California, Irvine
- Mortgage Bankers Association: Justin Wiseman, Mike Fratantoni, and Sara Singhas
- Mr. Cooper: Jay Bray and Dana Dillard
- National Community Stabilization Trust: Julia Gordon
- National Fair Housing Alliance: Lisa Rice
- Northern Ohio Investment Corp.: Mark Vinciguerra
- Ocwen: John Britti and Jill Showell
- Patricia McCoy: Faculty at Boston College
- PennyMac: David Spector and Karen Chang
- PricewaterhouseCoopers: Sherlonda Goode-Jones, Peter Pollini, and Genger Charles
- Quicken Loans: Mike Malloy, Pete Carroll, and Alex McGillis
- Self Help Credit Union/Center for Responsible Lending: Martin Eakes and Mike Calhoun
- Ted Tozer: Milken Institute, Former President of Ginnie Mae
- Union Home Mortgage: Bill Cosgrove
- U.S. Bank: Bryan Bolton
- Wells Fargo: Brad Blackwell, Raghu Kakumanu, and Laura Arce

Why Is the MSC Studying Servicing Compensation?

Servicing fees compensate mortgage servicers for managing loans from postclosing until they are terminated, either through payoff (i.e., at the maturity of the loan or earlier, the latter being more common), foreclosure, or a foreclosure alternative, such as a deed-in-lieu or short sale. Servicers receive a fixed fee annually, usually 25 basis points (or 0.25 percent)—although it can be as high as 50 basis points—of the unpaid principal balance for mortgages guaranteed by Fannie Mae and Freddie Mac. For government-insured loans, which are securitized into Ginnie Mae securities, servicing fees can vary from 19 to 69 basis points annually. Although the basis points are fixed for the life of the loan, the absolute dollar fee declines as the principal balance is paid down. Servicing fees are a component of the mortgage rate and are paid by borrowers as part of their monthly payment. The servicer retains the servicing fee portion of the monthly payment and passes the rest through to the investor who owns the loan.[1]

Servicer responsibilities vary drastically depending on whether a loan is performing or nonperforming (FHFA 2011). Before the Great Recession, servicing consisted primarily of generating monthly statements, collecting and processing borrower payments, and keeping track of fees and escrows. Most homeowners made their payments on time. For the small share of borrowers that went delinquent from time to time, servicers were required to engage in "loss mitigation" to minimize losses for loan investors, insurers, or guarantors. This can be a government entity (the FHA, the US Department of Veterans Affairs, or the US Department of Agriculture), a government-sponsored enterprise (Fannie Mae or Freddie Mac), or a private investor. Low default rates historically meant that servicers deployed a limited operational infrastructure for loss mitigation.

But the housing market crash and the resulting increase in delinquencies and foreclosures created significant stress for the precrisis servicing model. Servicers were still responsible for collecting and processing borrower payments and for minimizing investor losses, but the skyrocketing number of distressed borrowers in need of assistance required servicers to invest in and rapidly expand their operations at a time when the mortgage market was under tremendous financial stress.[2]

In addition, the entities owning, insuring, or guaranteeing the loan (such as Fannie Mae, Freddie Mac, government mortgage insurers, or private investors) can make material changes to loan servicing requirements after origination without changing servicing fees. During the last housing crisis, Fannie Mae, Freddie Mac, the FHA, the Department of Veterans Affairs, the Consumer Financial Protection Bureau, and the US Department of the Treasury developed new loss mitigation programs, revamp precrisis servicing policies, and created new regulations for the servicing industry. Some of these changes included requirements for every step of the loss mitigation process, such as how often and when servicers can contact a struggling borrower, what documentation to request from the borrower, and what loss mitigation options to offer in what order. As a result, servicing responsibilities and costs have increased.

In light of these changes, some believe that the structure of servicing compensation must be changed to better align servicing costs and revenues for performing and nonperforming loans in a manner that will improve outcomes for servicers and consumers. Others believe that the present compensation model, coupled with postcrisis reforms and recommendations from the previous MSC briefs, can promote an efficient servicing market with minimal risk of disruption. Whether and what changes to the servicing compensation model might be needed is an open question. The MSC studied servicing compensation and examined three specific options: the status quo, a fee-for-service model, and a central default utility model. In this brief, we discuss pros and cons of each model and assess how each would perform along the following dimensions:

- Industry preparedness for downturns
- Borrower outcomes
- Alignment of interests
- Access to mortgage credit
- Risk of market disruption

Because of lack of agreement on which model would work best, this brief neither represents consensus views of MSC members nor recommends any one model. Rather, it provides a window into how a diverse set of servicing market stakeholders view each option.

Structural Options for Servicing Compensation Design

Option 1: The status quo

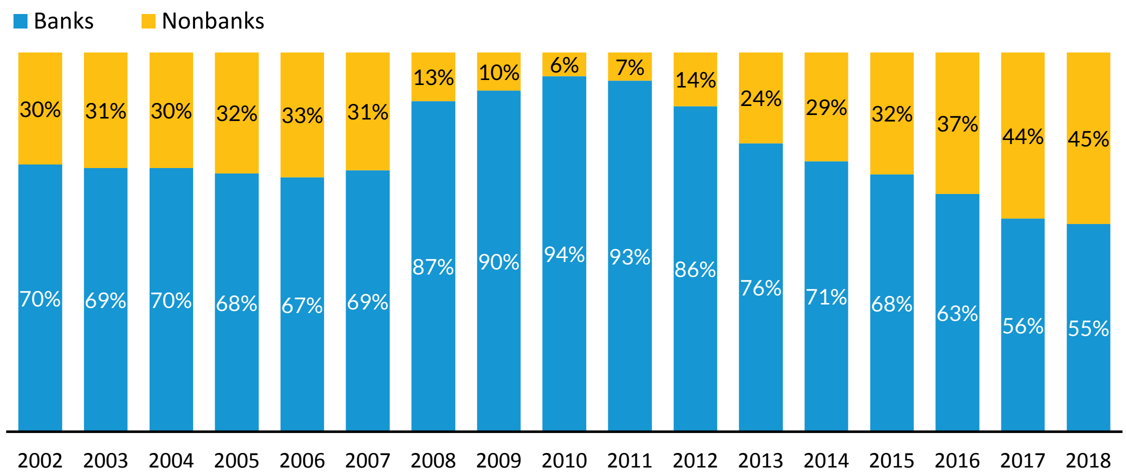
MSC members in favor of preserving the status quo believe that the current model, in conjunction with prior MSC recommendations, would reduce NPL costs and improve borrower outcomes. Today's servicing market is also much improved than the one going we had into the last recession given the reforms made since. For instance, the current loss mitigation toolkit is more robust than was the case historically—it includes loss mitigation programs for various distressed borrower scenarios, such as negative equity, job loss, and natural disaster. In addition, there is now better operational infrastructure for nonperforming loans, enabled by the rise of specialty default servicers, as well as stronger servicer oversight by loan guarantors, new consumer protection requirements,[3] and a high-quality postcrisis book of business.

Another argument in favor of retaining the present structure is to avoid the risk of disruption. Servicing compensation is not an isolated issue. Any changes to it will have implications for the scope of servicer responsibility, mortgage servicing rights (MSR) values and liquidity, servicer revenues, profitability, and customer service. Both bank and nonbank servicers would be affected, but nonbanks more so. The two have different business models and financing structures, with nonbanks more reliant on MSR financing.

Nonbanks have increased their servicing market presence in recent years as banks have pulled back. Before the housing crisis, banks serviced approximately 70 percent of outstanding unpaid principal balance of single-family mortgages. After peaking at 94 percent in 2010,[4] the bank share has declined gradually, ending 2018 at 55 percent, with nonbanks accounting for the remaining 45 percent (figure 1). It is unclear what impact new compensation model would have on MSR values. If negative, there would be implications for MSR financing and servicing capacity.

FIGURE 1

Bank and Nonbank Shares Based on Unpaid Principal Balance Serviced, 2002–18



Source: Urban Institute calculations based on Inside Mortgage Finance data.
Note: Shares from 2002 to 2004 are based on top 30 servicers, 2005 to 2007 shares are based on top 40 servicers, and shares from 2008 and onwards are based top 50 servicers.

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Maintaining the present compensation model also comes with a big risk, according to some members of the collaborative—it does not provide a formal structure to fund the high cost of servicing nonperforming loans. The cost of servicing performing loans is significantly lower than the annual 25 basis points in compensation (for conventional mortgages), but the cost of servicing nonperforming loans is substantially higher. Servicing NPLs is costly, high touch, and labor intensive because servicers must understand individual borrower circumstances, evaluate multiple loss mitigation options in accordance with investor guidelines, maintain effective and timely communication with borrowers, and recommend the best approach to cure delinquencies.

Servicers are also generally responsible for advancing principal and interest payments to securities investors, property taxes to local authorities, and escrows for homeowners' insurance using their own funds while the loan is delinquent. They eventually get reimbursed, but they must have financial resources to absorb significant cost escalations. This situation can create financial stress if more loans than anticipated default at the same time. NPL costs are high for all loan types but are especially acute for FHA loans because of inefficient loss mitigation, foreclosure, and conveyance processes and highly punitive timeline requirements. Servicing FHA NPLs is three times more expensive than servicing conventional NPLs (Kaul et al. 2018a). High NPL servicing cost is one of the reasons why access to credit for low- and moderate-income households remains tight by historical standards.[5]

Another shortcoming of the current compensation model has to do with the timing of when servicers get paid. Borrowers pay servicing fees monthly as part of the mortgage payment. Thus, servicers receive full servicing fees while a loan is performing but receive effectively nothing once it becomes nonperforming. This makes the business highly procyclical—it can be highly profitable in good times, but high costs and lost revenues can exacerbate financial stress during bad times. Ultimately, inadequate financial resources impair servicers' ability to respond effectively during downturns and lead to poor outcomes for borrowers, neighborhoods, and investors. Accordingly, some members of the MSC believe that the servicing compensation structure should be reformed to better align revenues with costs and improve preparedness for downturns. The MSC discussed two alternate compensation structures, each with its own benefits and risks.

Option 2: A fee-for-service model for nonperforming loans

Under this model, servicers would handle the servicing of performing loans as they do today. For the most part, their loss mitigation responsibilities would also remain the same. But the way they get compensated would change to ensure continued revenues, even for delinquent loans. Instead of receiving the full 25 basis point fee for performing and effectively nothing for nonperforming loans, servicers would retain less than 25 basis points while the loan is current. The remainder would be saved and tapped to pay for loss mitigation in one of two ways:

- Servicers could pay a predefined number of basis points on an ongoing basis to the loan insurer, guarantor, or investor (Fannie Mae, Freddie Mac, a government mortgage insurer, or a private investor). In return, these entities would agree to pay servicers flat dollar fees during delinquencies tied to specific loss mitigation actions and positive borrower outcomes.
- Alternatively, servicers could pay the same money into a separate insurance fund, thus bypassing the guarantors. The fund would pay servicers flat fees for delinquent loans based on loss mitigation tasks or outcomes. This approach would avoid concentrating more risk within loan guarantors, but it would require setting up a new entity.

Both alternatives would allow servicers to receive revenue while the loan is in default. A source of revenue in stressful times would improve systemic resilience and enable servicers to better serve struggling borrowers. To a limited extent, a version of fee-for-service is used today by government-sponsored enterprises[6] and the US Department of Housing and Urban Development,[7] generally to reimburse servicers for certain property preservation–related expenses. During the Great Recession, the federal government offered incentive payments to servicers for certain modifications under the Home Affordable Modification Program while it was in effect.[8] Some recent private-label securitization transactions[9] have gone further by paying servicers a small monthly fee to cover the cost of servicing performing loans. Once a loan becomes delinquent, these fees increase depending on the state of delinquency and loss mitigation success.

For example, under JPMorgan Mortgage Trust 2018–9, the servicer receives a base servicing fee of $20 per month per performing loan. Once a loan becomes 60 to 119 days delinquent, the servicer receives an additional $211 per month per loan. For loans at least 120 days delinquent, the servicer receives $252 per month. Although these fees help pay for general cost escalations, servicers are eligible to receive additional incentive fees for cured defaults, completion of loan modifications, and the like. For instance, they can earn $2,500 for completing a loan modification and $1,000 for curing a loan 60 or more days delinquent. Although there are multiple ways to structure a fee-for-service arrangement, the main purpose is the same—it provides servicers access to additional funds to meet their obligations to borrowers and investors during stressful times. More importantly, knowing they will not be on the hook for severe cost escalations for delinquent loans, lenders might be more willing to ease credit overlays.

But a fee-for-service model has drawbacks. It will need to build incentives that encourage proactive early intervention to minimize delinquencies. Some MSC members worry that the prospect of earning higher fees for delinquent loans could discourage servicers from pursuing aggressive early intervention to help prevent defaults in the first place. This could result in more loans becoming delinquent compared with the current system in which servicers—fearful of revenue loss—have a strong incentive to keep borrowers from going delinquent. Others believe higher fees would create better alignment of interests between servicers (greater incentive to cure defaults to earn higher fees), investors (reduced loan losses) and borrowers (more effective loss mitigation).

And because fee-for-service would be paid for using a portion of the 25 basis points strip, it would affect MSR valuation. The impact would depend on the ongoing fees servicers pay and the revenues they receive for NPLs, assumptions about expected default rates, and the discount rates used. Although the precise impact on MSR values requires further study, the risk is that if values are lower, servicers that hold MSRs on their balance sheets will have a less valuable asset compared with today, and servicers that sell or pledge MSRs to raise funds will receive less in return. Both banks and nonbanks would be affected, but the latter more so. Nonbanks depend more on MSR financing because, unlike banks, they lack access to consumer deposits and other diversified funding sources.

The MSC discussed mitigating the risk of disruption by making fee-for-service optional. Servicers could either keep the full 25 basis points fee for performing loans as today or pay a portion of it to have loan guarantors (or an insurance fund) absorb NPL costs. Servicers that prefer the status quo could retain it, while those who prefer fee-for-service could switch over. But it is doubtful this would work, given the risk of adverse selection. With optionality, there would be a temptation to use guarantors (or the insurance fund) only for loans that are more likely to default.[10] This can significantly raise the cost of seeking protection for servicers and render the whole structure economically unworkable. Additionally, having two compensation models in place could bifurcate the servicing market into submarkets, complicate MSR transfers, and affect liquidity.

Lastly, under the guarantor-centric approach, many risks and costs associated with NPL servicing would be shifted from servicers to the entity backing the loan, which ultimately holds credit risk. Some worry this would further increase risk concentration among guarantors (Fannie Mae and Freddie Mac) or government mortgage insurers (the FHA, the US Department of Veterans Affairs, and the US Department of Agriculture). The insurance fund structure avoids this risk, but the new entity that houses the fund would have to be built from scratch. It would have to build the expertise to monitor loan quality, manage credit risk, and price the insurance to ensure reserve sufficiency.

Option 3: A central default utility for nonperforming loans

Some members of the MSC support the creation of a central utility for default servicing. This would be a bigger change to the system than the fee-for-service model. It would change both the scope of work servicers perform and how they get paid for it. Servicers would continue to service performing loans as they do today but would outsource[11] the loss mitigation function to a central default utility once a loan becomes 60 days delinquent.[12] The utility would have a specialized, mission-like focus on curing delinquencies and would be financed in a manner similar to the fee-for service model—that is, using a portion of the servicing fee. This arrangement could be structured in two ways:

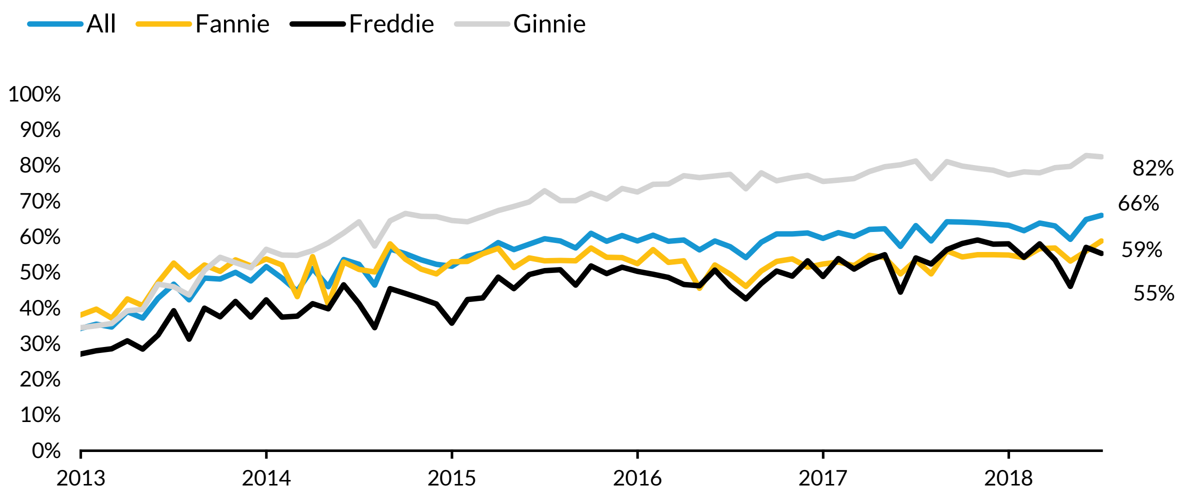
- Establish the utility as industry owned to align its interests with servicers. The utility would not necessarily have to build out its own end-to-end default servicing infrastructure. Instead, it would have the flexibility to do so, rely on specialized subservicers, or use a combination of the two. Servicers could fund the utility through direct ongoing contributions or through an insurance fund housed outside the utility. Using a fund would reduce risk concentration in the utility.
- Alternatively, servicers could pay the same fee to loan guarantors who would be responsible for loss mitigation. They could hire either the utility or the specialty subservicers.

Under both structures, servicers would no longer perform loss mitigation and would be largely freed from associated costs and risks. The scope of work for servicers would essentially be reduced to managing loans until they become 60 days delinquent. This would mitigate servicer financial and operational stress during downturns. More importantly, knowing they will not be on the hook for significant NPL costs escalations, lenders might be more willing to ease servicing-driven credit overlays.

The utility could benefit from better economies of scale. Although NPL servicing is a high-variable-cost business, it requires a substantial fixed-cost investment in operational systems and technology. Spreading these costs over a larger number of delinquent loans could mitigate per loan costs to some degree. A utility would also avoid the misaligned incentive issue with fee-for-service that concerns some MSC members. Because neither the utility nor servicers can receive additional compensation for NPLs, the incentive to earn higher profits from delinquent loans will not exist.

Despite these improvements, the utility model has some challenges. The first is the risk of adverse impact on MSR values, nonbank financing, servicing capacity, and liquidity. With nonbanks composing over 80 percent of FHA and VA originations and over half of GSE originations (figure 2), any repercussions would be widely felt.

FIGURE 2
Nonbank Origination Share by Agency



Source: Urban Institute Calculations based on eMBS data.

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The risk of disruption could theoretically be mitigated by making the utility model optional. Servicers would prospectively choose either status quo or pay ongoing fees to have the utility take over loss mitigation at 60 days delinquent. But how this would work is unclear, given that nonbank servicers will likely opt for status quo. Given their dominant market share, it is unlikely the utility model will work well without their participation. Optionality would also create an adverse incentive to tap the utility only for less creditworthy loans that are more likely to default. The utility could risk-based price, but if its portfolio is not well diversified across the credit spectrum, the cost of protection will be very high, rendering the model economically unsustainable. Some also worry that layering another risk-based pricing system on top of government-sponsored enterprise loan-level pricing adjustments and mortgage insurance premiums could price out even more borrowers with low credit scores. Lastly, there exists the risk of bifurcating servicing into submarkets, complicating MSR valuation and affecting liquidity.

There are also fears that the utility would have significant market power, which could lead to monopolistic behavior. Although structuring the utility as servicer owned would align its interests with those of servicers, it could still wield too much power over other market stakeholders that do not own the utility. This could reduce competition in default servicing, especially if the utility builds its own end-to-end platform. Specialty servicers that have built strong loss mitigation expertise over the years could find it difficult to compete.

According to some, anticompetitive fears could be addressed by structuring the utility as government run, similar to the Federal Deposit Insurance Corporation model with an explicit risk-based fee. It is, however, an open question as to how nimble a government entity would be in responding to borrowers in need of immediate assistance. It is also an open question as to how quickly a utility, whether industry or government owned, can ramp up operations during downturns without carrying too much excess capacity during good times.

The utility model would also concentrate the entire default servicing function and associated financial risks in a single entity. The amount of funding the utility receives will depend heavily on assumptions about future default rates and estimates of the utility's costs. If these risks are underestimated, the utility may not have adequate financial resources to carry out its responsibilities during severe economic downturns, thus increasing the risk of large insolvency.

Table 1 below summarizes pros and cons of each of the three options.

TABLE 1

Comparison of Options 1, 2, and 3

	Option 1: Status quo	**Option 2: Fee-for-service**	**Option 3: Central utility**
Ability to respond during downturns	No impact	Improved	Improved
Compensation for servicing NPLs	No compensation	Some compensation	Some compensation
Profitability on performing loans	No impact	Lower	Lower
MSR values	No impact	Unclear	Unclear
Risk of market disruption	Lowest	Higher	Higher
Concentration risk	Lowest	Higher, can be mitigated	Higher, can be mitigated
Servicing-driven credit overlays	No impact	Fewer overlays	Fewer overlays
Borrower outcomes	No impact	Better, but risk of misaligned incentives	Better, but risk of monopolistic behavior

Note: MSR = mortgage servicing rights; NPL = nonperforming loans.

Conclusion

This brief, the final of the MSC, is an attempt to rekindle the conversation about mortgage servicing compensation. Some MSC members believe the compensation model should be changed, while others support status quo. Those in favor of change believe the present model leaves us inadequately prepared to respond during downturns, as it does not include a formal mechanism to pay for the high cost of servicing nonperforming loans. Those in favor of the status quo contend that those costs are best mitigated by implementing the reforms outlined in prior MSC issue briefs—that is, by improving the loan modification toolkit for government loans, reforming the FHA's foreclosure and conveyance processes, and establishing uniform mortgage servicing data standards.

The MSC discussed three compensations options—the status quo, a fee-for-service model, and a central utility model. Each option has pros, cons, and risks. Some of these issues—such as the potential impact on MSR values, servicer revenues, and profitability—need to be studied in greater detail. Given these risks and trade-offs and the lack of agreement on how to mitigate them, the Mortgage Servicing Collaborative does not recommend any one option over the other. However, by making its collective thinking public, the collaborative intends to inform future policy discussions on servicing compensation.

Notes

1 For a basic understanding of mortgage servicing, please see the "Servicing 101" videos produced by the MSC, available at "Help Me Understand Mortgage Servicing," Urban Institute, accessed April 15, 2019, https://www.urban.org/policy-centers/housing-finance-policy-center/projects/mortgage-servicing-collaborative/help-me-understand-mortgage-servicing.

2 For an MSC video explaining the basics of default servicing, see "What Is Default Servicing?" Urban Institute, accessed April 15, 2019, https://www.urban.org/policy-centers/housing-finance-policy-center/projects/mortgage-servicing-collaborative/help-me-understand-mortgage-servicing/what-default-servicing.

3 Mortgage Servicing Rules Under the Truth in Lending Act (Regulation Z), 83 Fed. Reg., 10553 (March 12, 2018).

4 Part of the crisis-era increase in bank share was caused by banks acquiring nonbanks.

5 FICO scores for today's mortgage originations are about 30 points higher than those observed during the reasonable lending standards of early 2000s. See Goodman (2014).

6 "Servicing Guide," Fannie Mae, accessed April 15, 2019, https://www.fanniemae.com/content/guide/servicing/f/1/05.html.

7 Edward L. Golding, "Update of Preservation and Protection (P&P) Requirements and Cost Reimbursement Procedures for Title II Forward Mortgages and Home Equity Conversion Mortgages (HECMs)," mortgagee letter 2016–02 to all FHA-approved single-family mortgagees, February 5, 2016, https://www.hud.gov/sites/documents/16-02ML.PDF.

8 See the "Making Home Affordable Compensation Matrix," Home Affordable Modification Program, accessed April 15, 2019, https://www.hmpadmin.com/portal/programs/docs/hamp_servicer/mha_compensation_matrix.pdf.

9 "J.P. Morgan Mortgage Trust 2018–9 presale report," S&P Global, accessed April 15, 2019, https://www.spratings.com/documents/20184/769219/PresaleJPMorganMortgageTrust.pdf/276b1882-d5df-3ef7-20cd-933f9a01693b.

10 This temptation could be mitigated by requiring a "representative mix."

11 Under an outsourcing arrangement, the servicer would continue to own servicing rights, be responsible for advancing delinquent principal and interest, and remain on the hook for any regulatory and reputational risk. The utility, functioning much like a large subservicer, would focus on loss mitigation and achieving positive borrower outcomes. The alternative would be to transfer servicing rights and associated risks and obligations to the utility. However, that could distract the utility from its core mission of loss mitigation, as it would have to manage and hedge a highly volatile asset class, hold capital, and become subject to extensive regulation.

[12] Engaging the utility at 60 days would be optimal because loans that are 30-days delinquent often self cure. Waiting until the loan becomes 90-days delinquent would delay loss mitigation and reduce the likelihood of cure.

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About the Authors

Karan Kaul is a research associate in the Housing Finance Policy Center at the Urban Institute. He publishes innovative, data-driven research on complex, high-impact policy issues to improve the US mortgage finance system. A strategic thinker and thought leader with nearly 10 years of experience in mortgage capital markets, Kaul has published nearly 100 research articles on such topics as mortgage servicing reforms, efficient access to credit, benefits of alternative credit data and scoring models, and single-family rentals. He has advocated for efficient industry practices, regulation, and legislation to make the mortgage market work better for all Americans. Kaul is the lead researcher on the Mortgage Servicing Collaborative and regularly speaks at housing conferences. Before joining Urban, he spent five years at Freddie Mac as a senior strategist analyzing the business impact of postcrisis regulatory reforms. He holds a bachelor's degree in electrical engineering and a master's degree in business administration from the University of Maryland, College Park.

Laurie Goodman is a vice president at the Urban Institute and codirector of its Housing Finance Policy Center, which provides policymakers with data-driven analyses of housing finance policy issues that they can depend on for relevance, accuracy, and independence. Goodman spent 30 years as an analyst and research department manager on Wall Street. From 2008 to 2013, she was a senior managing director at Amherst Securities Group LP, a boutique broker-dealer specializing in securitized products, where her strategy effort became known for its analysis of housing policy issues. From 1993 to 2008, Goodman was head of global fixed income research and manager of US securitized products research at UBS and predecessor firms, which were ranked first by *Institutional Investor* for 11 straight years. Before that, she held research and portfolio management positions at several Wall Street firms. She began her career as a senior economist at the Federal Reserve Bank of New York. Goodman was inducted into the Fixed Income Analysts Hall of Fame in 2009. Goodman serves on the board of directors of MFA Financial and Arch Capital Group and is an adviser to Amherst Capital Management, a member of Morningstar Credit Ratings Regulatory Governance Board, and a member of the Federal Reserve Bank of New York's Financial Advisory Roundtable. She has published more than 200 journal articles and has coauthored and coedited five books. Goodman has a BA in mathematics from the University of Pennsylvania and an AM and PhD in economics from Stanford University.

Alanna McCargo is vice president for housing finance policy at the Urban Institute, where she focuses on management, development, and strategy for the Housing Finance Policy Center, including the cultivation of innovative partnerships within Urban and with external stakeholders. McCargo has over 20 years of experience in housing finance, policy, and financial services. She has worked in the private, public, and nonprofit sectors on programs, policies, and research to improve access to housing and mortgage finance. Before joining Urban, McCargo was head of CoreLogic Government Solutions, working with federal and state government agencies, regulators, government-sponsored enterprises, think tanks, and universities to deliver custom data, analytics, and technology solutions to support housing and consumer policy research. Previously, McCargo held leadership roles with Chase and Fannie Mae, managing portfolios, policy efforts, and mortgage servicing transformation and alignment. From 2008 to 2011, she was an agent of the US Treasury Department on housing programs, such as Making Home Affordable and Hardest Hit Funds, working with industry stakeholders on the recovery. McCargo serves on nonprofit boards and committees, focusing on her passion for helping underserved populations with financial literacy, economic stability, and housing security. She works with Doorways for Women and Families, Women in Housing and Finance, and DC Habitat for Humanity. McCargo has a BA in communications from the University of Houston, an MBA from the University of Maryland, and an executive certificate in nonprofit management from Georgetown University's McCourt School of Public Policy.

Tod Hill-Jones is the policy program manager at the Urban Institute's Housing Finance Policy Center. He manages and coordinates all aspects of the center's high-profile programs and research. Previously, Hill-Jones served six years as senior director of government affairs at the Financial Services Roundtable's Housing Policy Council, where he directed the council's government affairs efforts in advocating on the mortgage and housing marketplace interests of HPC member companies in legislative, regulatory, and judicial forums. Most notably, Hill-Jones led financial service industry efforts to improve industry compliance with the Servicemembers Civil Relief Act and the new Military Lending Act. Hill-Jones is an honorary admiral of the Texas Navy and an honorary colonel from the Commonwealth of Kentucky for distinguished service in government for his work on service member and military veteran affairs issues. Hill-Jones previously worked in quality and risk management with CitiCapital, a subsidiary of Citigroup from 2000 to 2008 and was active in Texas politics as a campaign and political consultant for more than 10 years. Hill-Jones graduated from the University of Texas at Arlington, where he was competitively selected to be a Bill Archer Fellow and received a BA in political science with a minor in philosophy.

Acknowledgments

This brief was made possible by members of the Urban Institute's Mortgage Servicing Collaborative. We are grateful to them and to all our funders, who make it possible for Urban to advance its mission.

The views expressed are those of the authors and should not be attributed to the Urban Institute, its trustees, or its funders. Funders do not determine research findings or the insights and recommendations of Urban experts. Further information on the Urban Institute's funding principles is available at urban.org/fundingprinciples.

500 L'Enfant Plaza SW
Washington, DC 20024

www.urban.org

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