

WHAT IS SERVICING WORTH?

By Tom Healy, CMB

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The servicers who optimize servicing worth are those that have a customer (i.e. mortgagor) service perspective in all loan administration activities.

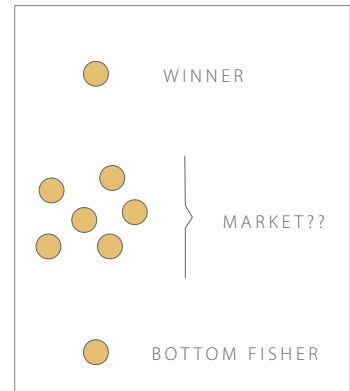
Studies show convincingly that developing complex relationships with mortgagors, through multiple products, increases dramatically the probability that your customers will stay with you, or at least think of you first, when the time to refinance comes about.

There is much discussion in trade, accounting, and regulatory literature about the value of servicing. Much of the discussion focuses on “fair value,” which is generally defined as the amount at which an asset could be bought or sold in a current transaction between willing parties. Any relationship between fair value and servicing worth, however, is purely coincidental. Fair value may change significantly from quarter to quarter; worth rarely does.

Fair value for servicing rights is simply the price at which a portfolio could be sold. This price, while important for accounting and regulatory purposes, may not represent worth for a variety of reasons.

First -- uncertainty tends to be a decrement to price. If buyers in the marketplace do not have complete knowledge of the prepayment, credit and operational risks inherent in a portfolio, they will tend to be conservative and assume the worst. And, by definition, they will not have complete knowledge.

Second -- if a portfolio is brought to the auction market, it is probable that a series of bids will be received. It is not atypical to receive a dispersion of bids as illustrated below. There is often-times a bottom fisher, hoping the rest of the market is asleep. There are usually a series of bids that are fairly tightly banded. And, of course, there is the winner; i.e., the highest bidder.



There has been discussion among valuation analysts as to whether the “fair value” should be the price you would get with high reliability (i.e., the tightly banded bids); or the price you could get



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Third -- and most important, is the fact that fair value ignores the influence of the entity that owns it. As a great football quarterback can excel or fail based on his team association, a servicing portfolio can thrive or wither based on its corporate ownership. The worth of the quarterback or servicing portfolio is greatly influenced by its environment.

The influence of corporate ownership includes the following competencies intrinsic to a firm:

ORIGINATIONS

Servicing is a self-liquidating asset. It is diminished by both prepayments as well as amortization of mortgagors' principal balance. Because the preponderance of revenue from portfolios comes from service fees, revenues drop inexorably over time. Costs do not follow in tandem.

Costs are unit driven, not principal balance driven. Additionally, they come under inflationary pressures and are often fixed in the short run. It is very difficult to cut loan administration costs 50% because half of your portfolio paid off. As a result, costs on a per unit basis tend to go up over time.

Originations, therefore, are critical. The servicing shop is like a beast that must be fed. Servicing volume must be maintained, through purchases or originations, or margins will decline and, absent intervention, decline to the point where exiting the business is the only economically viable option. Since relying on the servicing purchase market to maintain critical mass is risky (it relies on a fairly thinly traded market where you need to always be the highest bidder), originations are critical to “feeding the beast.” Those that are capable of doing this create a higher worth than those that are simply exposed to the vagaries of prepay speeds.

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CUSTOMER SERVICE

While many in the servicing industry believe that prepayments are a financial risk that need to be hedged, I would suggest that they really represent a marketing risk. There are two major reasons why you lose your customers to a competitor: (1) the mortgage servicers are pulled away by a better price (see Originations above), or (2) they are pushed away because of inadequate service. Most mortgage servicers barely know who their servicer is. To the extent they do, it is often because they had a bad experience. The servicers who optimize servicing worth are those that have a customer (i.e. mortgage) service perspective in all loan administration activities.

CROSS-SELLING

The MBA cost study showed that the typical mortgage servicer earned only \$103/loan/year in 2005. Servicing is clearly a high transaction volume/low profit margin business. This \$103 included \$33.00/loan/year of ancillary income. Servicers that are able to cross sell additional products to their mortgage servicers have a decided advantage in servicing worth over servicers that do nothing but loan administration.

Additionally, studies show convincingly that developing complex relationships with mortgage servicers, through multiple products, increases dramatically the probability that your customers will stay with you, or at least think of you first, when the time to refinance comes about. This adds tremendous worth.

OPERATIONAL EFFICIENCY

In most high transaction volume/low profit margin businesses such as servicing, the benefits eventually migrate to the low cost producers. This does not mean, however, that all servicing will wind up in the hands of Countrywide, WAMU, Wells Fargo or the other mega-servicers. Servicing is not a homogenous asset. There is a huge array of servicing types that lend themselves to different niche players.

For instance, there is a growing belief in the marketplace that credit issues will accelerate over the next several years. Delinquencies and foreclosures have been going up, and this trend is expected to continue. Firms that are efficient at handling troubled loans may be able to create more worth from such portfolios than those that focus on clean, plain-vanilla agency type products. This may also be true with some of the more exotic products such as reverse mortgages, sub-prime, multiple-payment option mortgages, and others. Finally, geographically concentrated products may well have more worth to a local servicer than a national firm because of the former's better understanding and expertise in local servicing regulations and practices.

RISK MANAGEMENT

This area of management often gets short shrift but is what separates survivors from failures and, thus, contributes mightily to worth. One-third of the Fortune 500 corporations have traditionally disappeared after only 20 years. The average lifespan of the largest U.S. corporations is, in fact, only 40 years. Many have disappeared not because their financials were slightly out of line with their peers but because of major disasters.



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Barings Bank, Homeside, Long Term Capital Management, Enron, Adelphia, and many others all succumbed to catastrophic events. Hurricanes in New Orleans, the Texas real estate bust of the mid-80s, Black Monday in 1987 — all contributed to the demise of many more firms. Had these events been explored as eventualities ahead of time, such failures might have been averted. “It’s not the things you don’t know that get you into trouble ... it’s the things you know for sure that ain’t so.” (anonymous).

Servicing fair value does not equal worth. In fact, evidence shows that the worth of servicing portfolios over the last five years (2002-2006) bears little resemblance to the fair values ascribed to them in 2002. No one anticipated the spate of refinancings that the industry experienced throughout this period. We will only truly know a servicing portfolio’s worth after the fact, when we can look back and see what happened. We will only then be able to see the revenues earned, the prepayments and retention rates, and the costs. We will see that worth is not simply a reflection of perceived market value, but rather a value that is created by the servicing owner.

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