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Nonbank Specialty Servicers: What's the Big Deal?

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Introduction

The recent explosive growth of nonbank specialty servicers has prompted calls for regulatory intervention. A July 2014 report from the Inspector General of the Federal Housing Finance Agency (FHFA), on the risks these servicers posed to government-sponsored entities (GSEs) in particular, fueled the issue, which has been debated since the end of the crisis. Earlier this year, Benjamin Lawsky, the superintendent of the New York State Department of Financial Services, halted the bulk sale of mortgage servicing rights (MSRs) from Bank of America to Ocwen, the nation's largest and fastest-growing nonbank specialty servicer.

Nonbank specialty servicers are non-deposit-taking companies with a specific focus on servicing troubled loans (i.e., those that are delinquent or in default). Such companies now hold about $1.4 trillion in servicing rights out of a nearly $10 trillion market (FHFA OIG 2014). Although banks still hold the vast majority of mortgage servicing, nonbank servicers have quickly expanded their market share. In 2011, the 10 largest mortgage servicers were all banks; since 2013, 5 of the top servicers have been nonbanks. Concern at the state level has scaled up to the national scene, with Representative Maxine Waters (D-CA) and FHFA officials including the Inspector General, the Consumer Financial Protection Bureau (CFPB), and the Financial Stability Oversight Council (FSOC) all arguing that the growing volume of mortgage servicing performed by nonbank specialty servicers warrants additional attention and, potentially, policy action (CFPB 2013; FHFA 2014; FHFA OIG 2014; FSOC 2014; Waters 2014).

This commentary discusses some of the major concerns that have been raised about the largest nonbank servicers, focusing on the three fastest-growing large nonbank servicers:

- Ocwen Financial Corporation;
- Nationstar Mortgage; and
- Walter Investment Company.

In the past year, their astonishing growth alone has served as a catalyst for increased regulatory scrutiny (see table 1). We begin by exploring the regulatory

Table 1: Top 10 Mortgage Servicers, 2011–Q1 2014

Overall Market Rank	Top 10 Servicers by Market Share, Q1 2014	Nonbank Servicer Ranking	2011 Market Share	Q1 2014 Market Share	Change in Market Share 2011–Q1 2014
#1	Wells Fargo	NA	18%	18%	4%
#2	Chase	NA	11%	10%	-11%
#3	Bank of America	NA	17%	8%	-54%
#4	***Ocwen***	***#1***	1%	4.5%	350%
#5	***Nationstar***	***#2***	1%	3.9%	290%
#6	Citi	NA	5%	3.9%	-25%
#7	US Bank	NA	2%	2.9%	27%
#8	***Walter***	***#3***	0%	2.4%	NA
#9	***PHH Mortgage***	***#4***	2%	2.3%	30%
#10	***Quicken Loans***	***#5***	NA	1.5%	NA

Source: Inside Mortgage Finance.

and market framework driving the striking growth of nonbank specialty servicers, and then address the major charges against them, in an effort to elevate the debate and inform sound policy.

The Growth of Specialty Servicers

Commercial banks remain the dominant owners of MSRs, but nonbank servicers are growing quickly. According to data from Inside Mortgage Finance (IMF), of the 30 largest mortgage servicers, nonbank firms held a 17 percent share of the mortgage servicing market at the beginning of 2014, up from 9 percent at the end of 2012, and 6 percent at the end of 2011. In the past two years, commercial banks have begun reducing their balance of MSRs. Between 2012 and first quarter (Q1) 2014, Bank of America reduced its MSR footprint by 40 percent, and more than halved its overall share between 2011 and Q1 2014. In contrast, the country's largest nonbank servicers (in descending order, Ocwen, Nationstar, Walter, PHH, and Quicken) saw their market share grow by between 30 percent and 350 percent between 2011 and Q1 2014.

For performing loans, mortgage servicing is a relatively straightforward process: servicers oversee the collection of payments, respond to borrower inquiries, track principal and interest paid, and, if necessary, initiate foreclosure proceedings. Traditionally, servicing has been handled by the originating bank (or one of its affiliates), and the banks that are responsible for originating most US residential loans tend to dominate the servicing space (e.g., Bank of America, JP Morgan Chase, and Wells Fargo, among others). The servicing platform used by such banks is equipped to handle large volumes of performing loans and, prior to the financial crisis, this was a generally successful and efficient model.

Beginning in 2007, however, when growing numbers of delinquent borrowers needed a higher level of interaction with their loan servicers, it became clear that the big banks' servicing platforms were ill equipped to adapt to the shifting demand. Traditional banks lacked the technical capacity to handle the growing volume of distressed loans, leading to foreclosure logjams and poor modification systems. The introduction of the Home Affordable Modification Program (HAMP) created guidelines for streamlined loan modifications and oversight of the modification industry, but its benefits were slow to accrue to needy borrowers (GAO 2014).

Recognizing that ineffective servicing was exacerbating the unfolding crisis, regulators urged banks to sell their mortgage servicing rights to nonbank servicer firms that specialized in servicing loans requiring a higher level of interaction between servicer and borrower (FHFA OIG 2014). The activities of the three largest nonbank specialty servicers by market share—Ocwen, Nationstar, and Walter—are the focus of the remainder of this commentary. These three entities have been targeted by regulators and have been subject to intense media attention, are the fastest-growing nonbank specialty servicers, and have evolved in ways that have contributed to growing regulatory interest.

We do not focus on PHH and Quicken, nonbanks with growing servicing arms whose primary business nevertheless is mortgage origination.

Similarly, we do not focus on small nonbank servicers, because so much of the servicing market is dominated by large servicers: as of Q1 2014, 58 percent of the mortgage servicing market was being handled by the top 10 largest servicers (data from IMF). Ocwen has expanded by acquiring smaller competitors, which have struggled with increasing compliance costs and declining inventory. "[T]he sheer volume of new regulations ... and the expense of that" was cited by the CEO of Mortgage Contracting Services—a national mortgage field servicing firm based in Tampa, Fla.—as a reason for its merger with two smaller companies in August 2013 (Bay 2014). And as we move farther from the crisis, the "decline in inventory of [distressed residential mortgages also] is spurring consolidation among special servicers" (Kilgore 2014).

The growth of specialty servicers has been facilitated by regulatory efforts to reduce credit losses by transferring servicing rights on government-owned or -guaranteed loans to specialty servicers. In 2008, Fannie Mae introduced its High Touch Servicing Program, and in 2011, purchased servicing rights to 384,000 loans from Bank of America with the intent of redistributing them to specialty servicers (FHFA OIG 2012). Consequently, specialty servicers began scaling up their operations to handle higher amounts of delinquent loans. As these servicers became more adept at handling high volumes of distressed loans, banks gradually became more comfortable unloading their servicing rights to them, scaling up the volume of MSR transfers and contributing to the growth of nonbank specialty servicers. Later, as banks emerged from the crisis, the volume of distressed loan transfers to specialty servicers continued apace, because banks were eager to distance themselves from the reputational damage incurred during the crisis.

The growth of nonbank specialty servicers has also been influenced by regulatory reforms—in particular, Basel III, the postcrisis update to the international Basel banking supervisory standards designed to strengthen the safety and soundness of financial institutions and markets. Adopted by the United States in 2013, Basel III made the cost of holding on to servicing rights significantly more capital intensive for banks. Because specialty servicers aren't obliged to follow the same capital requirements as banks, their desire to acquire loan portfolios at a time when banks are eager to offload their distressed loan portfolios has been something of a natural response to different regulatory regimes (for more, see Goodman and Lee 2014).

To recap, key factors contributing to the en-masse shift of mortgage servicing from banks to specialty servicers have included the difficulty big banks have had in managing large volumes of distressed loans,[1] regulatory encouragement for banks and GSEs to transfer distressed loan servicing to specialty servicers, and regulatory reforms leading to the differential treatment of MSR assets for banks and nonbanks.

While the top three servicers experienced stagnant or declining market shares between 2011 and 2014,[2] Ocwen's market share increased by 350 percent and Nationstar's increased by 290 percent (see table 1). Thus, in 2013, two specialty servicers, Ocwen and Nationstar, finally broke into the ranks of the top five mortgage servicers. As the volume of servicing has shifted from banks to specialty servicers, regulators have become nervous that these nonbank servicers are not regulated or supervised in the same way as banks.

Traditionally, nonbank institutions have been left to the states, but the extent of oversight and consumer protections varies and, with severe resource constraints at the state level, many state regulators have lacked the capacity to enforce state laws and protections. Moreover, the concern is not simply that banks are subject to more regulations than nonbanks, but also that banks are subject to *continuous*, often on-site regulatory oversight. Although one might question how much good this did in the past, Dodd-Frank reforms have resulted in more rigorous supervision, by both bank regulators and the CFPB. And while nonbanks are now subject to CFPB supervision, and the CFPB's complaint database provides the agency with important information that regulators have traditionally lacked, the CFPB is a relatively new agency, and cannot provide quite the degree of coverage or continuous supervision of traditional bank regulation.

FHFA and DFS Raise Concerns about Specialty Servicers

The FHFA Office of the Inspector General (OIG) released a report on July 1, 2014, that raised concerns about the risks nonbank specialty servicers pose to Fannie Mae and Freddie Mac. While this report comes at a time of growing regulatory scrutiny, it was not the first time that the FHFA OIG has raised concerns about nonbank specialty servicers. In 2012, OIG reviewed Fannie's High Touch Servicing Program as part of two evaluations: a general assessment of the FHFA's process for reviewing

[1] Said then-Secretary of the Department of Housing and Urban Development (HUD) Shaun Donovan on the announcement of the $25 billion attorneys general settlement in 2012, "One of the most important ways this settlement helps homeowners is that it forces the banks to clean up their acts and fix the problems uncovered during our investigations. And it does that by committing them to major reforms in how they service mortgage loans" (http://www.justice.gov/opa/pr/2012/February/12-ag-186.html).

[2] Between 2011 and 2013, the largest servicer, Wells Fargo, experienced a 4 percent growth in its share of the servicing market, Chase experienced a 9 percent decline, and Bank of America had a 52 percent decline.

business decisions made by the GSEs, and a separate assessment of the 2011 transfer of MSRs on 384,000 loans from Bank of America to Fannie Mae. In these reviews, the OIG raised concerns about the complexity of and risk associated with large MSR transfers to specialty servicers, including potential disruptions with loss mitigation efforts under way under the prior servicer. In 2012, the OIG recommended that the FHFA consider developing procedures for reviewing significant MSR transactions, which has led the FHFA to require the GSEs to secure FHFA approval for any MSR transfers of portfolios exceeding 25,000 loans. As part of its July 2014 report, the OIG recommended that the FHFA develop a more comprehensive, formal oversight framework for examining and mitigating risks posed by nonbank specialty servicers.

At the same time that the FHFA was raising concerns, New York's newly formed Department of Financial Services (DFS) also entered the debate. Headed by Superintendent Benjamin Lawsky, the DFS has jurisdiction over licensed mortgage bankers in New York state. In 2012, the DFS reviewed and approved Ocwen's purchase of another loan servicing firm, Litton, on the condition that Ocwen remedy Litton's mishandling of foreclosures. During and after the DFS's follow-up, Lawsky grew concerned about Ocwen's servicing standards and handling of loan modifications. In early 2014, Lawsky halted Ocwen's purchase of $39 billion in MSRs from Wells Fargo, citing concerns about Ocwen's capacity to handle the added servicing load (184,000 loans). As of June 2014, the transaction is still on hold. Later, Lawsky raised additional concerns about the nature of Ocwen's business partnerships and apprehension that Nationstar's rapid growth might create capacity issues that put homeowners at risk.

The Concerns

Diverse regulatory concerns about the growth of specialty servicers have coalesced around four major themes:

1. **Capacity:** Has the industry developed an adequate support infrastructure to keep up with rapidly expanding portfolios?
2. **Servicing Transfers:** Can servicers transfer thousands of high-touch distressed loans in a way that does not interrupt service to distressed borrowers?
3. **Financial Risks and Regulations:** Given their unique volatility and liquidity issues, should these nonbanks be subject to the same or a different regulatory standard than banks?
4. **Business Affiliations:** Does the significant vertical integration common among the big nonbanks lead to self-dealing that justifies regulatory oversight?

1. Capacity

Capacity is a legitimate concern given the fast growth of this consumer-focused industry as well as its genesis in the housing crisis. To get a sense of the industry's infrastructure capacity, it's useful to look at staffing levels. In 2013, Fitch Ratings, one of the credit rating agencies that rates large bank and nonbank servicers, looked at how staffing levels differed between bank and nonbank servicers. It found that following an increase in late 2010, bank staffing levels declined as defaulted loans were resolved or transferred, while staffing levels at nonbanks rose as their portfolios expanded. By 2012, the number of loans per employee for banks had decreased significantly, from 800 to 500, while the average number of loans per employee at nonbanks remained steady, at 275, between 2010 and 2012. This suggests that the nonbanks were increasing their staffing as they were acquiring bulk servicing rights, keeping their loan-per-employee ratio steady. However, the number of loans per employee at nonbanks grew from 300 in Q2 2012 to 400 in Q4 2013. The recent growth in the number of loans per employee could result in poorer service or a similar level of service provided with greater efficiency. The numbers alone don't tell the complete story.

Ocwen, the nation's largest and fastest-growing specialty servicer, has expanded its staffing significantly as it has acquired servicing rights to more loans, even during the period after 2012. According to Morningstar's Operational Risk Assessments (ORAs), in one year, Ocwen increased its overall staffing by 104 percent, growing from 5,000 employees in June 30, 2012, to 10,190 employees a year later. This staffing growth outpaced Ocwen's servicing portfolio growth of 77 percent during the same period (from 586,563 loans with an unpaid principal balance [UPB] of $94.3 billion to 1,093,557 loans with a UPB of $173 billion).

Morningstar's 2012 ORA noted that Ocwen's "proprietary RealServicing enterprise wide loan servicing system … is fully scalable and can support more than twice the current servicing portfolio," indicating that at least in 2012, the company was able to support a much larger servicing load.

Offshore Employees

Ocwen has been criticized for its heavy reliance on offshore employees. In 2012, according to the *Wall Street Journal*, Fannie Mae expressed concerns about "whether proper controls [could] be enforced with call centers in foreign jurisdictions," which could complicate the safeguarding of private financial information (Berthelsen and Johnson 2012). At that time, 82 percent of Ocwen's 5,000 employees were located in India. But by mid-2013, Ocwen had increased its domestic staff by 455 percent, from 843 to 4,680 US-based employees. In that same period, offshore staff also grew, but at a much slower pace (32 percent, from 4,141 to 5,450 employees based in India). Looking at raw human capital, it appears that, at the very least, Ocwen has been increasing its staffing capacity apace with its increased servicing portfolio. It's worth noting that Ocwen has the most offshore employees of the three largest specialty servicers, and while Nationstar also has offshore employees, Walter does not. A 2014 evaluation by S&P noted, "Ocwen manages a majority of customer interactions including late-stage collection and loss mitigation with counselors offshore in India," and found that while other servicers may "handle customer service and early-stage delinquency interactions offshore, no other residential servicer [ranked by S&P] currently provides a significant portion of late-stage collection and loss mitigation operations offshore" (S&P 2014). S&P also reports that many of the other servicers it ranks previously offshored collection call center staff to India, but have returned those roles to onshore sites in response to customer feedback.

Consumer Complaints

Some advocates and policymakers view the increased volume of consumer complaints against nonbank servicers as evidence that they are unable to meet the needs of their growing consumer base. The evidence, however, is mixed and, depending on the source, indicates that nonbank servicers receive either more, less, or equivalent complaints as bank servicers. For example, in its 10th annual survey of housing counselors and attorneys, the California Reinvestment Coalition found that while complaints against the largest banks continue unabated, Nationstar and Ocwen are increasingly listed among the worst offenders (CRC 2014). This finding, however, may reflect that these two servicers now serve a larger consumer base in California (and elsewhere) than they have in the past.

According to a Compass Point analysis of the CFPB's complaint database, while Ocwen, Nationstar, and Walter all rank high in terms of total number of complaints reported to the CFPB, they also service a disproportionate amount of distressed loans compared with their bank peers, and according to the CFPB's data, over half of mortgage-related complaints have been related to loan modifications, collection, or foreclosure—that is, borrowers in distress (Barker, Boltansky, and Seperson 2014). Looking only at complaints on delinquent loans serviced (see table 2), Compass Point found that Ocwen, Nationstar, Walter, and other nonbank servicers "hav(e) the lowest amount of modification/foreclosure complaints per delinquent loan out of the largest mortgage servicers in the US" (Barker et al. 2014).

Going forward, policymakers must gauge whether complaints against the largest specialty servicers reflect true deficits in infrastructure and an inability to service a growing customer base, or reflect the growing customer base and the nature of that base—that is, exclusively nonperforming borrowers. Moreover, it is important to take into account the possibility that consumer outcomes vary because of differing resolutions offered by the different firms: as two groups of researchers have found, similarly situated borrowers experience diverse outcomes due to differences among servicers in the types of resolutions offered (Reid, Urban, and Collins 2014; Tian, Quercia, Ratcliffe, and Riley 2014).

Percent of Loan Modifications

This diversity in borrower outcomes has led to allegations that nonbank servicers perform fewer loan modifications than their peers. On this front, the truth is anything but clear, and modifications often vary by firm, rather than by firm type (bank versus nonbank servicer). Moreover, variations in loan modifications may reflect the more demanding nature of distressed

Table 2: Number of Loan Modification/Foreclosure Complaints as Percent of Number of Delinquent (DQ) Loans

Company	1Q12	2Q12	3Q12	4Q12	1Q13	2Q13	3Q13	4Q13	Total Complaints per Average DQ Loans
Bank of America	0.2%	0.4%	0.5%	0.4%	0.9%	0.9%	0.7%	0.4%	**3.8%**
Wells Fargo	0.3%	0.4%	0.3%	0.3%	0.6%	0.6%	0.4%	0.2%	**3.1%**
Ocwen	0.3%	0.4%	0.4%	0.3%	0.2%	0.2%	0.1%	0.1%	**2.0%**
JPMorgan Chase	0.2%	0.4%	0.3%	0.3%	0.6%	0.6%	0.5%	0.3%	**3.2%**
Citigroup	0.2%	0.2%	0.2%	0.3%	0.5%	0.4%	0.4%	0.3%	**2.6%**
Nationstar Mortgage	0.1%	0.1%	0.1%	0.1%	0.1%	0.2%	0.2%	0.1%	**1.3%**
Walter Financial	0.1%	0.1%	0.1%	0.1%	0.1%	0.1%	0.1%	0.1%	**0.8%**
USB	0.4%	0.6%	0.4%	0.5%	1.1%	1.2%	0.9%	1.8%	**6.2%**
PNC	0.4%	0.5%	0.4%	0.6%	0.8%	1.0%	0.7%	0.5%	**5.0%**
SunTrust Banks	0.5%	0.5%	0.5%	0.5%	0.8%	0.8%	0.6%	0.5%	**4.7%**
PHH	0.1%	0.3%	0.4%	0.3%	0.5%	0.2%	0.2%	0.2%	**2.1%**
Industry	**0.3%**	**0.4%**	**0.5%**	**0.4%**	**0.8%**	**0.9%**	**0.6%**	**0.4%**	**4.3%**

Source: Barker et al. 2014.

loans acquired and serviced by specialty firms. Fitch Ratings found that loan modifications by bank servicers decreased to 26 percent in the last half of 2012, from 57 percent in the first half of 2010; in contrast, for nonbank servicers, loan modifications ranged between 69 to 71 percent during the same period (Fitch Ratings 2014). In its latest quarterly servicing index, Fitch found that loan modifications in Q4 2013 accounted for 63 percent of loss mitigation actions taken by nonbank servicers of nonagency mortgage-backed securities, versus 35 percent for banks, which also relied on a much higher share of short sales than nonbanks (Fitch Ratings 2014). The slight decline in modifications by nonbanks may reflect the quality of loans being handled at this stage, which have likely already been modified and failed, and thus do not qualify for further modifications, and the slight increase in modifications by banks may reflect that they have transferred most of their worst-quality book of business to nonbanks, and are now dealing with higher-quality distressed loans that qualify for modifications.

While HAMP represents only a portion of each servicer's overall mortgage servicing operation, there are significant HAMP data available. Assuming that such data are illustrative, the data on HAMP loan modification request approvals indicate that between the program's 2009 inception and April 2014, Ocwen and Nationstar approved fewer loan modifications than the biggest banks (Treasury 2014). While Bank of America, CitiMortgage, JPMorgan Chase, and Wells Fargo had approval rates of 43 percent, 44 percent, 29 percent, and 30 percent, respectively, Ocwen, Nationstar, and Green Tree Servicing (which is owned by Walter) had approval rates of 22 percent, 15 percent, and 40 percent, respectively. While Green Tree has equivalent modification rates, Ocwen and Nationstar have much lower lifetime HAMP approval rates. However, if we look at activity for one recent month, April 2014, the nonbank servicers look more like their peers: Ocwen and Bank of America approved 9 percent of HAMP modifications, and Nationstar had a 20 percent approval rate, while Wells Fargo had a 16 percent approval rate. Walter's Green Tree actually approved 36 percent of modifications, a much higher percentage than most of the largest banks that month. The low nonbank HAMP lifetime approval rates may reflect that the banks are moving their most highly delinquent loans to nonbanks, while holding onto better-performing loans. It may also reflect the reality that nonbank servicers have more subprime loans and less prime loans. Subprime loans are less apt to pass the test that requires a modification to be net present value (NPV) positive.[3] Additionally, if we base servicing quality on HAMP approval rates, then Green Tree Servicing comes out looking very good, with a HAMP lifetime

[3] Lenders calculate the NPV of mortgages to evaluate whether it is more cost-effective to provide a borrower with a loan modification or to foreclose. It estimates the likelihood that a borrower will go into default again and eventually end up in foreclosure anyway. If the results of the test show a modification will be NPV positive, then the investor will get a greater return from a loan modification; if the results are NPV negative, then a foreclosure is more economical for the investor.

approval rate of 40 percent and a 36 percent approval rate in April 2014 alone. However, Green Tree Servicing was recently cited by the Office of Mortgage Settlement Oversight for failing more metrics at any one time than all of the other banks and servicers that are subject to compliance tests under the 2012 national mortgage settlement (OMSO 2014).

Resolution Speed

Fitch also found that nonbanks have shorter timelines for resolving delinquencies: as of 2012, nonbanks averaged 14 months to resolve loans through a repayment, modification, short sale, or foreclosure, whereas banks averaged 22 months. The shorter time frame, however, does not necessarily suggest that borrowers fare better in the hands of nonbanks, since a fast foreclosure when a modification would have been possible is not necessarily a positive outcome for a borrower. Additionally, some research suggests that longer timelines make no differences in the ultimate default rate (Gerardi, Lambie-Hanson, and Willen 2011).

Outcomes

Finally, research has produced varying conclusions about borrower outcomes at the hands of nonbank versus bank servicers. In an analysis of 4 million individual loans from over 100 US servicers, Reid et al. (2014) found that loan cure rates (the percentage of delinquent loans returning to a current payment status each month) were not universally better or worse across nonbank servicers and banks. On the other hand, an analysis of loans to low- and moderate-income borrowers through Self-Help Credit Union's Community Advantage Program found that, controlling for revealed risk profile, loans transferred to specialty servicers had lower rates of foreclosure than loans that were not transferred to specialty servicers (Tian et al. 2014).

2. Servicing Transfers

Servicing transfers are quite complex in and of themselves, and the transition from one servicer to another not uncommonly results in service interruptions to borrowers in distress. Regulators are eager to ensure that borrowers in large MSR transfers are adequately protected, given that many affected borrowers may be in the middle of loss-mitigation procedures at the time of transfer. In January 2014 this led the CFPB to implement new rules to ensure that most servicers have appropriate policies and procedures in place to protect consumers during MSR transfers. Given the newness of these rules, it is unclear whether they will result in improved consumer outcomes.

To date, most of the large MSR transfers to specialty servicers have been comprised of legacy, high-touch, distressed loans, and although transferring MSRs to nonbanks may sever the traditional bank–borrower relationship, it's worth considering whether such transfers may optimize outcomes for all parties. As noted above, the existing evidence is mixed: some research indicates that loans transferred to specialty servicers avoided foreclosure at a higher rate than loans not transferred to specialty servicers (Tian et al. 2014), and other, related research indicates that differences in individual servicer loss-mitigation practices influence loan outcomes as much as servicer type (Reid et al. 2014). In other words, who the servicer is matters more than whether the servicer is a bank or nonbank.

Moreover, variability in servicer quality appears to be complicated by lack of transparency around whose interests are being served by specific loss-mitigation practices. In some cases, modifications may be in the best interest of the borrower and servicer, but not investors who may believe a modification that substantially cuts the borrower's principal balance and interest rate provides them less return than a quick foreclosure. (All modifications are required to be NPV positive, but many investors do not believe these tests are correctly applied.) In other cases, modifications may be in the best interest of the investor, borrower, and servicer, when the modification successfully avoids an expensive foreclosure and results in a steady stream of payments. As Reid et al. note, borrowers and investors may be assisted by regulations that ensure "all similarly situated borrowers receive consistent treatment, regardless of who their servicer is," and additional transparency about how servicers make their loss-mitigation decisions would also improve outcomes.

3. Financial Risks and Regulations

That nonbank specialty servicers are lightly regulated has been viewed as an impetus for highly regulated banks to transfer their servicing rights to them. It also has compelled federal and state regulators to consider imposing prudential banking standards, such as capital requirements and liquidity and risk management oversight, on nonbank specialty servicers (FSOC 2014; Ivey 2014). As the FHFA OIG (2014) stated, "these new servicers have less stringent regulatory and financial requirements than banks." While it is true that nonbanks face many of the same risks as banks—that is, interest rate and prepayment risks—nonbanks' financial stability is more sensitive to market changes, because their income relies so much on one highly volatile asset (MSRs). This raises the question of whether nonbanks require the same standard of regulation as banks—or perhaps a higher or different standard.

Undiversified, Volatile Asset

As noted, while nonbank servicers may require more regulation, it is unclear that they should be treated in the same way as banks. The value of servicing rights can fluctuate sharply depending on changes in interest rates; generally, as interest rates decline and loans are prepaid to take advantage of refinancing, the total value of existing servicing rights declines because no further servicing fees are collected on repaid loans. It's important to understand that nondistressed servicing is more sensitive to prepayment and interest rate changes than distressed servicing, because distressed loans cannot refinance easily; however, specialty servicers are disproportionately affected by interest rate and prepayment rate volatility because their portfolios are undiversified, consisting solely of MSRs. The extreme volatility in MSR asset values makes it difficult to understand how existing assets are affected by market shifts, and how much capital is needed for their financial stability and to protect borrowers, lenders, and investors. To some extent, servicers have developed structures to reduce earnings volatility and shed prepayment risk, by transferring it to investors. In February, for example, Ocwen launched a synthetic security designed to transfer interest rate risk from itself to the capital markets. But such structures have yet to be deployed on a large scale (Goodman and Lee 2014).

Liquidity Concerns

In addition to the question of the appropriate level of capital for nonbank servicers, liquidity issues can lead to operational problems for specialty services, especially those that service loans in private label securitizations (PLSs). After they purchase MSRs, specialty servicers remit payments to the owner of the loan, either through a trustee in a PLS or to the mortgage originator if it still holds the loan. If borrowers whose loans are in a PLS miss their payments, servicers are still responsible for advancing payments to the PLS trust. To do this, nonbank entities borrow from deposit-taking institutions, because they lack a deposit base from which to draw funds. They pay high interest rates on these advances—and while servicers will be repaid for the advances when the loan is foreclosed, modified, or otherwise paid off, they are not compensated for the higher interest rates charged and may be responsible for advances for an extended period of time.

The resource-intensive process of servicing distressed loans, coupled with the lack of liquidity and obligation to potentially make substantial advances to investors over extended periods of time, has allegedly led servicers to pursue outcomes calculated to reduce costs and stay financially viable, at the expense of investors and borrowers. In March 2013, for example, Nationstar was sued by a group of investors who alleged that the servicer auctioned off loans in bulk for a fraction of their value, "allowing them to more quickly recoup certain advances they made on the mortgage loans as part of their servicing duties" (*KIRP LLC vs. Nationstar Mortgage LLC* 2013). In other words, they believe Nationstar's actions were driven by a need to reduce costs and increase profitability by converting illiquid MSR assets into cash, even though the sale did not produce the highest return to the investors. (The investors also questioned whether the nonperforming loan sales were permitted by the pooling and servicing agreements governing these transactions.)

4. Business Affiliations

Specialty servicers argue that they are able to cost-efficiently work with borrowers to modify or otherwise service their loans due to economies of scale derived over years of working with growing numbers of distressed borrowers. Such efficiencies, they argue, are achieved through business affiliations with other entities, such as providers of loan originations, securitizers, or foreclosure management firms. The level of vertical integration of the largest nonbank servicers stands in marked contrast to the big banks, which have been more reluctant to embark on the same degree of business alignment. Recently, regulators have argued that these affiliate relationships incentivize servicers to act in ways that are not in the investors' or borrowers' interest, and instead, maximize profits for the allied companies.

Nationstar, for example, has been acquiring companies (see figure 1) as its portfolio has expanded, with the goal of delivering wraparound services that support Nationstar's financing arm. Not listed in figure 1 but mentioned in the aforementioned Nationstar lawsuit is auction.com, a "business partner" to which the investors allege that Nationstar "route[d] business to [benefit Nationstar]" (*KIRP LLC vs. Nationstar Mortgage LLC* 2013).

Ocwen also has spun off several companies (see figure 2), which has led regulators to investigate whether the business connections have led to self-dealing at the expense of consumers and investors. In a February 26, 2014, letter, NY DFS Superintendent Lawsky asked for clarification about the nature of Ocwen's relationship with Altisource Portfolio Solutions, Altisource Residential Corporation, Altisource Asset Management Corporation, and Home Loan Servicing Solutions—all of which are chaired by Ocwen's CEO, who also is the largest shareholder in each company (Lawsky 2014a). The NY DFS points out, "Ocwen's management owns stock or stock options in the affiliated companies … rais[ing] the possibility that management has the opportunity and incentive to make decisions … that are intended to benefit the share price of affiliated companies, resulting in harm to borrowers, mortgage investors, or Ocwen shareholders."

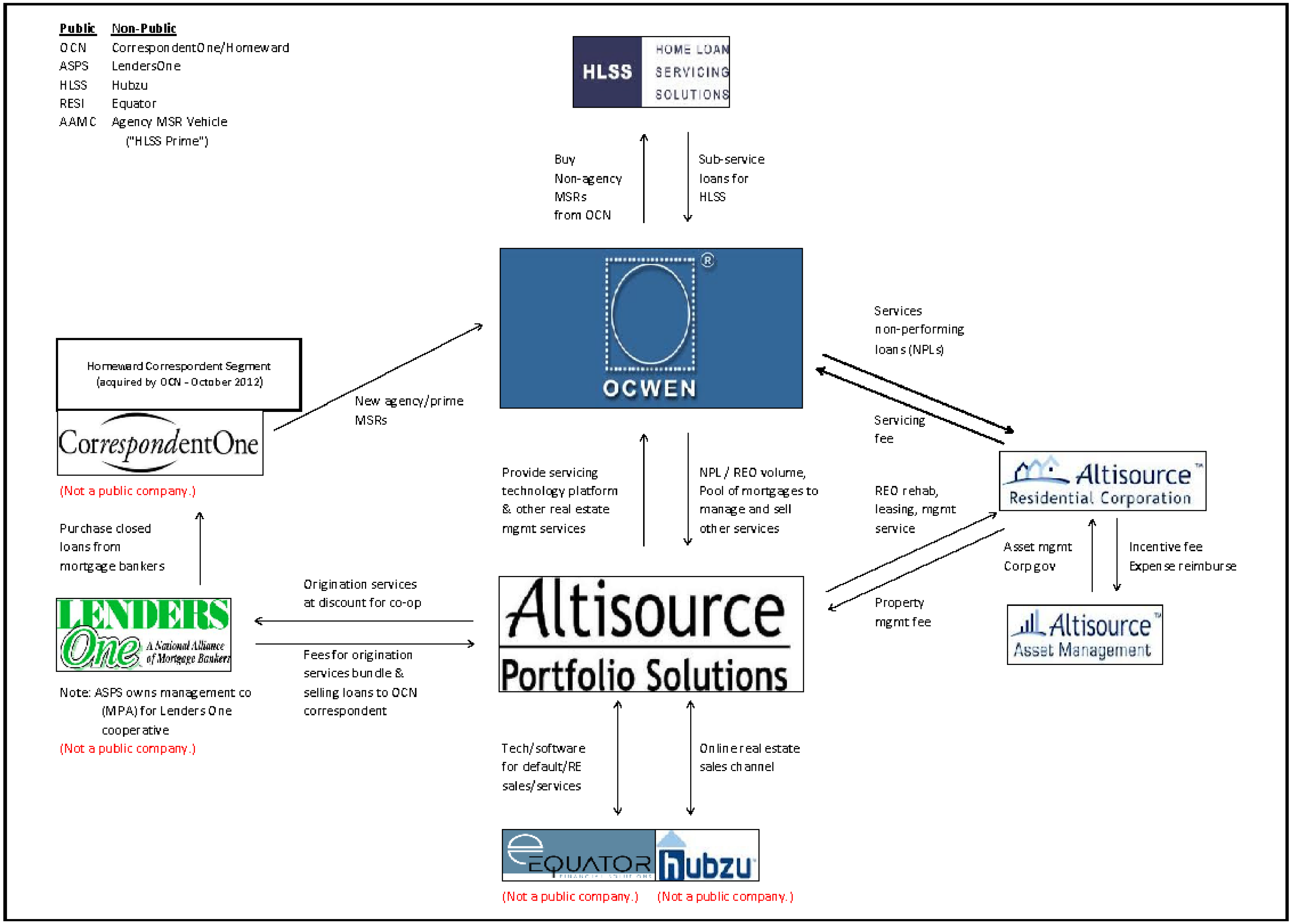
In April 2014, Lawsky sent another letter specifically questioning Ocwen's relationship with Altisource Portfolio, which has an eight-year agreement to manage distressed and repossessed homes in Ocwen's servicing portfolio (Lawsky 2014b). Altisource Portfolio requires that properties be listed and marketed through Hubzu, even if a distressed borrower already signed a contract for a short sale. Ocwen's executive chairman owns or controls 26 percent of Altisource Portfolio's stock. In the letter, Lawsky notes, "Hubzu appears to be charging auction fees on Ocwen-serviced properties that are up to three times the fees charged to non-Ocwen customers … when Ocwen selects affiliate Hubzu to host foreclosure or short sale auctions … the Hubzu auction fee is 4.5%; when Hubzu is competing for auction business on the open market, its fee is as low as 1.5%." Lawsky goes on to say, "The relationship between Ocwen, Altisource Portfolio, and Hubzu raises significant concerns regarding self-dealing," which may negatively impact homeowners and mortgage investors. This contrasts with claims by specialty servicers that their subsidiary companies and business alignments are designed to create efficiencies for customers and investors. According to a recent *American Banker* article, while "[m]arketing and selling homes online is … supposed to reduce the cost of buying a home[, i]n practice, affiliated businesses have done the opposite, and homes purchased through sites like Hubzu or auction.com can include total commissions of 9 percent to 11 percent" (Berry 2014).

Regulators are still trying to understand the nature of these business relationships, and should consider whether better disclosure of fees and increased transparency with respect to business alignments may lead to better outcomes for consumers and investors. Vertical alignments may lead to real cost savings and economies of scale, but because they also lead to self-dealing, to the detriment of investors and consumers, there is a strong case to be made for more transparency and disclosure.

Figure 1: Nationstar Business Affiliations

Source: Nationstar Mortgage 2014.

Figure 2: Ocwen Business Affiliations



Source: Barker and Stewart 2014.

Conclusion

It does not appear that nonbank specialty servicers perform worse as a group than bank servicers; in fact, they may actually provide better service to delinquent borrowers given the difficult loans they tend to service. It is unclear exactly what steps regulators will take to provide more oversight and regulatory supervision in the nonbank specialty servicer space. The only certainty seems to be that more regulation is coming, because nonbank specialty servicers have become such an important part of the mortgage market, servicing a large and growing proportion of outstanding mortgage debt. In its July report, the FHFA OIG recommended that the FHFA enhance oversight of nonbank specialty servicers through a more consistent, standardized approach, including a risk management process and comprehensive framework to examine and mitigate risks. Regulators should consider the development of regulations that improve the safety and soundness of this channel, rather than those that eventually close it down. Ultimately, the question regulators need to face is how to best encourage all servicers to perform optimally for consumers, investors, and lenders, as well as for shareholders.

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