

# A MODEL FOR EFFICIENT MORTGAGE SERVICING





After nearly a decade of Herculean efforts and difficult decisions, mortgage servicing leaders are reaping their reward: another round of hard decisions. This time the battle is for efficiency. On the one hand, it is clear that the industry cannot afford to support the servicing model it put in place to respond to the financial crisis. On the other hand, almost no one likes the idea of cutting back processes, standards, and controls—basically re-creating the dangerous status quo of 2007. What is a servicer supposed to do?

The mortgage servicing industry has changed tremendously over the past decade. While delinquency rates have steadily decreased since the height of the financial crisis, direct mortgage servicing costs have risen at a compound annual growth rate of 14 percent from 2009 to 2014, according to data from the Mortgage Bankers Association. Federal, state, and local government regulation have increased, regulatory scrutiny and enforcement have intensified, and compliance has become a major priority. As a result, the average annual direct cost to service a loan has ballooned from \$55 in 2007—precrisis—to more than \$170 in 2014.<sup>1</sup>

Now, as the housing market and the regulatory environment stabilize, the industry is emerging into a new steady state. A spate of transactions have also rebalanced servicing portfolios, with nonbanks' share more than tripling from 7 percent in 2012 to 24 percent in 2015.<sup>2</sup>

In this environment, servicing leaders have a new concern. Where just a few years ago, the priority was compliance at all costs, today the focus is on profitability as well. The environment, however, doesn't give servicers many tools to affect profitability. Servicing fee revenue schedules are stable, gains and losses on the valuation of mortgage servicing rights are difficult to manage (particularly in volatile market conditions), and the current interest rate environment keeps interest income low. The cost of servicing did decline for many participants in recent periods primarily because delinquency rates have fallen to less than half of peak rates.<sup>3</sup> (Delinquent loans cost more than ten times as much to service than regular loans.<sup>4</sup>) But additional reductions in cost are necessary to achieve profitability goals and create a sustainable model.

This paper shows how to reduce servicing expenses without jeopardizing stability. The journey begins with the development of a cost fact base that allows servicing leaders to tackle their largest cost types—workforce and technology—and improve their performance in critical servicing activities that tend to be cost hot spots—quality assurance and customer service.<sup>5</sup> The payoff for servicers? A sustainable model for mortgage servicing that frees resources for other investments including origination growth.

4 Mortgage Bankers Association 2015 Servicing Operations Study, 2014 data for prime servicers

<sup>1</sup> Mortgage Bankers Association 2015 Servicing Operations Study, 2014 data for prime servicers

<sup>2</sup> U.S. GAO. "Nonbank Mortgage Servicers," March 2016. (Percentage is of unpaid principal balance)

<sup>3</sup> Delinquency Rate on Single-Family Residential Mortgages, Federal Reserve Bank of St. Louis; 11.26% in Q1 2010 and 5.17% in Q42015

<sup>5</sup> We do not focus on costs related to default servicing in this paper. Although they remain a major driver of the overall cost base at most institutions, they have been heavily scrutinized since the crisis.

#### DEVELOPING AN ACTION-ORIENTED VIEW OF COSTS

Developing and maintaining a detailed view of costs is a crucial step in reducing servicing expenses. Cost transparency highlights opportunities for greater efficiency—what costs should change, how they should change, and how the changes will affect the rest of the business.

To make cost data truly actionable, servicing leaders need to know:

- Who owns which costs?
- What drives specific costs?
- How long it will take to bring about change?

Many servicers will find it useful to invest in a new cost framework, separating servicing costs by type, then categorizing them according to a plain language taxonomy of servicing activities. A framework of this sort enables a clearer understanding of overall servicing costs and allows cost owners to drill down into each servicing activity to better understand the composition of its costs. Whenever possible, the cost framework should draw on existing information sources such as human resource databases and technology application logs. By linking the cost framework to the general ledger, it can be monitored and updated over time.

Effective cost reporting avoids both paralyzing granularity – costs do not need to be accurate to the tenth of a penny to inform decision-making – and prevents overly simplistic conclusions. For example, we have seen servicers try to shrink their loan portfolios to lower costs without taking into consideration how significant fixed costs are in mortgage servicing.

<b>COST TYPES</b>	EXAMPLES	CATEGORIZATION
Personnel-related	Salary, benefits for servicing employees	<ul> <li>Map to servicing activities (e.g. customer service, quality assurance) to expose redundancies or overlaps across roles</li> </ul>
Ancillary	Equipment, professional fees, vendor payments	<ul> <li>Map to servicing activities when possible (e.g. most outsourcing-related costs)</li> <li>Categorize remaining costs in appropriate account groups</li> </ul>
Technology	Hardware, software, employee tech	<ul> <li>Categorize in appropriate account groups</li> <li>Specify whether the cost is servicing-specific or shared by other owners (e.g. some servicing applications at banks)</li> <li>Map to servicing activities when appropriate (e.g. servicing apps)</li> </ul>
Support costs	Risk, finance, compliance, human resources	<ul> <li>Categorize by whether the cost is servicing-specific or shared by other owners (e.g. some support teams at banks)</li> <li>Map costs to a taxonomy of activities provided by support functions</li> </ul>
Centrally managed costs and true overhead	Occupancy, special initiatives, office of the CEO	Segment by account

#### Exhibit 1: Effective servicing cost framework example<sup>1</sup>

1 Cost ownership and characteristics are not shown on the framework due to space limitations, but they are vital for cost management efforts.

Armed with an effective cost framework and reporting, cost owners begin to manage costs. They can:

- Compare costs to benchmarks to identify hot spots
- Identify overlap in activities across servicing team and support functions
- Identify owners who are empowered to change costs and hold them accountable<sup>6</sup>
- Assess the costs associated with performing activities in-house and locally versus offshoring or outsourcing
- Create scenarios to analyze how costs will change in response to changes in portfolio volume or how long they will linger if an activity is terminated

The remainder of this paper provides starting points and recommendations for common cost issues that servicers may choose to address.

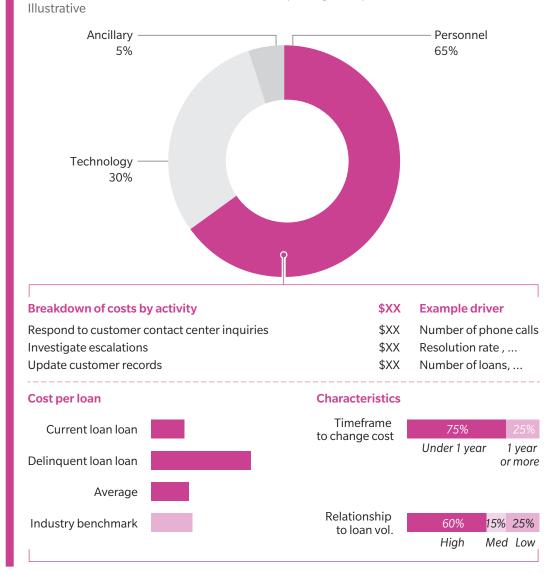


Exhibit 2: Customer service breakdown cost reporting example

6 At a typical bank servicer, the personnel-related and ancillary costs will be owned by the servicing executive while the remaining costs will be allocated through a corporate allocations process

### OPTIMIZE THE WORKFORCE

Payrolls grew sharply during the financial crisis and the period immediately following it, as companies staffed up with skilled and highly compensated workers to handle skyrocketing delinquency and new regulatory requirements. Although mortgage servicing workforces shrank by 15 percent between 2012 and 2014, these efforts focused mainly on easy-to-cut costs.<sup>7</sup> More challenging areas of spend such as bloated management structures have proven hard to address. As a result, at most companies, personnel cost will represent the single largest opportunity to reduce costs, and the workforce still typically accounts for 30 to 40 percent of total servicing costs today.<sup>8</sup>

The target-state operating model, including the expected size and composition of the portfolio, should guide personnel cost management. Most servicers have (or should have) capacity models to translate this target state into specific role and site requirements. These models should account for fluctuations in staffing needs across days of the week and weeks in the month. In most cases managerial layers can be reduced, roles consolidated, and spans of control expanded. In some cases, companies can reduce overall skill level of the workforce commensurate with the work being performed and reconsider the mix of specialists and generalists. Servicers can increase workforce flexibility by training teams on more than one set of tasks.

Reducing the number of locations can lower costs while increasing efficiency. We have seen servicers whose vacant rent costs amounted to more than 50 percent of their occupied rent costs because they maintained numerous small sites with shrinking numbers of staff. Running subscale operations in numerous locations also impedes knowledge sharing and makes flexible team staffing more challenging.

Servicers should be alert for other common issues that require changes to the workforce and operating model:

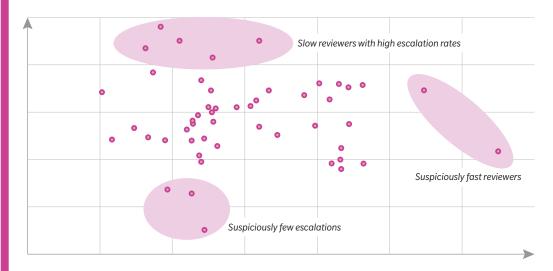
- Duplicative responsibilities across roles and "shadow functions" in the servicing business that replicate enterprise functions' responsibilities
- Underused shared-service capabilities
- Organizational silos that inhibit beneficial collaboration
- Activities whose original purpose is no longer required, for example, unnecessary reporting
- Offshoring and outsourcing opportunities, and conversely, prior offshoring and outsourcing decisions that have failed to deliver expected benefits
- Excess project management support

<sup>7</sup> Mortgage Bankers Association 2015 Servicing Operations Study

<sup>8</sup> Mortgage Bankers Association 2015 Servicing Operations Study, client benchmarks

Thoughtful performance management can be a boon to workforce efficiency. Beneficial practices include individual productivity targets and metrics supported by insightful reporting. (See Exhibit 3.) Regular campaigns and competitions with well-defined incentives can improve worker performance. For additional impact, incentive plans can be designed to support servicer goals. Within these plans, agents can be grouped by performance, training plans can be developed to reduce dispersions, and best practices can be shared from top performers. Given complex compliance requirements in some elements of servicing, it is important to include work quality as a performance indicator and avoid misaligned incentives.

## **Exhibit 3:** Example of performance reporting for a manual loan review team Illustrative



ESCALATION RATE

AVERAGE NUMBER OF LOANS REVIEWED PER DAY

#### EVALUATE TECHNOLOGY NEEDS AND CAPABILITIES

At the typical servicer, about 15 percent of total costs go to direct and allocated technology.<sup>9</sup> One major reason is the array of mortgage servicing software applications that have emerged in the past decade to help servicers do their increasingly complex job. It is possible to find individual companies that employ 200 or more servicing applications at an average cost per application of several hundred thousand dollars.<sup>10</sup> As a result, application consolidation offers a significant opportunity for saving money and increasing efficiency. Process digitization tools are another meaningful opportunity.

Communication between business and technology partners is often difficult, and less-thansuccessful communication is the root cause behind many failed cost management efforts. To lay the groundwork for technology cost management, servicers can prepare an inventory of applications: their costs, their purpose, and whether they are shared with other users outside of mortgage servicing. By linking applications to a taxonomy of servicing activities, the application inventory uses a shared language for collaboration and empowers business partners to provide guidance to technology partners.

Underused applications should be consolidated or retired to eliminate direct and indirect maintenance costs. Technology solutions put in place during the crisis that continue to play important roles should be evaluated; in many cases they may not be fully integrated with other systems yet and require manual work that should be automated.

Although a primary goal is to streamline and reduce technology complexity, in select areas, investments in new technology can accelerate the process of becoming more efficient. These often include tools that digitize paper-based processes, enable customer self-service, and enhance interactions with customers, such as user interfaces, knowledge management, and automated call-back. Issue logs and quality assurance data can identify the processes that are causing painpoints so they can be prioritized for technology investment.

9 Mortgage Bankers Association 2015 Servicing Operations Study, 2014 data for prime servicers, client benchmarks 10 Oliver Wyman observations

### ENSURE QUALITY WITH AN AGILE APPROACH

In the years since the financial crisis, many companies have adopted "belt and suspenders" approaches to servicing mortgages—expanding quality assurance capabilities within the servicing function while also beefing up corporate risk and compliance oversight functions. But doubling up on controls and quality checks is expensive, and it can lead to a false sense of security.

An alternative approach—one already in use at innovative companies—is to manage risk through agile methods that lead to both more effective controls and more efficient operations. Typical opportunities include using electronic checklists to monitor quality at key points; reducing overlap in roles and responsibilities between first and second lines of defense; and creating performance management metrics, targets, and rewards to incentivize quality.

# A more agile approach to manage quality also takes a hard look at controls through a two-part inventory process:

- 1. Is the control needed?
  - Has an underlying risk been clearly identified and articulated?
  - Is the risk material?
  - Has the option of tolerating the inherent risk been considered and deemed insufficient?
  - Has a risk-management objective been articulated? What would be an acceptable level of residual risk to remain?
  - Have approaches for the risk aside from treatment been exhausted?
  - Have treatments aside from controls been exhausted?

- 2. Does the control require improvement?
  - Is there a clearly articulated control objective—for example, the impact the control will have in reducing the risk to an acceptable residual level?
  - Has the control been designed to generate artifacts to facilitate testing and assurance by second and third lines of defense?
  - Does the control as designed directly reduce risk to an acceptable residual level, beyond the impact of other treatments already in place?
  - Has the control been assigned a single accountable person who owns the control and is empowered to change it?

Once an agile design for quality is in place and a baseline assessment of controls has been completed, in-process continuous improvement is key to maintaining an effective risk-based compliance and quality assurance program. The process starts with simple, effective reporting to identify issues and skilled analysts to assess root causes. It also requires empowering employees with the tools, capabilities, and authority to address root cases of breakdowns, eliminate rework, and share best practices on an ongoing basis.

### TRANSFORM CUSTOMER SERVICE

Customer service is typically one of the highest-cost servicing activities. A core set of best practices can significantly increase servicers' ability to deliver effective customer service while managing costs. There are two basic objectives: to reduce the need for costly agent-based customer service and to deliver agent-based service more effectively. To support both objectives, customer service issues shoulde be tracked and their root causes identified.

A key tool in reducing the need for agent-based service is to invest in strong self-service tools—then lead customers to use them via incentives or "nudges". Self-service tools can be modified on an ongoing basis to address root causes of customer issues. For instance, if a new regulator-mandated disclosure is driving call volume, the voice recognition system can start with a related prompt: "Are you calling about the letter you just received? Press one to learn what it means for you."

Highly effective communication can preempt issues that lead customers to reach out to agents. Common situations such as changes in escrow payments tend to generate significant confusion (unsurprising given many servicers' unclear escrow statements). The best communication follows simple guiding principles.

BEST PRACTICES	EXAMPLE	
Give perspective	<ul> <li>"Most homeowners' insurance premiums change every year based on their insurance companies' policies"</li> </ul>	
Keep it clear and simple	• "Here's a calendar with the deadlines for your modification highlighted on it"	
Guide to the right next step	<ul> <li>"If you would like to learn more about how escrow payments are calculated, please visit this website"</li> </ul>	
Show partnership	• "You're a great customer, and we want to make sure you know when your payments are due going forward"	

Some customer service needs cannot be fully automated. What remains must be dealt with effectively and efficiently to minimize costs. Servicers should aim to resolve as many issues as possible on the first contact. Customer service agents need sufficient training and authority to resolve issues at the first call. First-call resolution rates should be recorded and monitored to ensure ongoing improvement, and root causes of common issues should be eliminated. Many servicing operations already have access to high-quality tools and training in their teams that specialize on delinquent mortgages, where regulatory concerns make efficient, effective service a high priority – access to these tools and trainings can be expanded to improve agent performance overall.

Another powerful tool to increase the effectiveness of customer service is customer segmentation, which is often absent in mortgage servicing, even at institutions that embrace it in other areas. With effective segmentation in place, servicers can tailor their approach to service delivery. For example, one large servicer used predictive modeling to identify "high touch" loan modification applicants who generated twice the normal number of calls and

complaints; it then adapted the service model for these customers to pre-empt issues with more proactive outreach.<sup>11</sup> Segmentation can also identify customers for whom it is strategic to provide "white-glove" service, such as customers with significant holdings of other products with a bank servicer. Meeting the needs of these customers effectively preserves valuable relationships.

#### LOOKING FORWARD: REALLOCATING SPEND TO DELIVER BETTER SERVICE

Servicers benefit from a clear and actionable view of costs. With cost transparency, servicers can identify starting points to address the difficult task of improving efficiency. And for managers keen to reinvent servicing—by delivering distinctive customer experience, for example—better cost management gives them the resources to make those investments. This is especially true for bank servicers who face significant cost pressure in a revenue-challenged environment. When servicing is profitable, servicers can pursue strategic priorities such as improved refinance recapture, digitization, and customer experience enhancements, putting them in a fundamentally better position for the future.

11 Oliver Wyman observation

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