

# SERVICING MANAGEMENT

## Time For the Annual Checkup

*Servicing managers need to face problems aggressively, fix them correctly and fix them early.*

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by JOE GARRETT and CORKY WATTS

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Doctors will always tell you that it's best to come in for an annual checkup, even if you're feeling fine. Their position is that they have a better sense of your overall health if they see you when you're not in the middle of a medical crisis.

After years of observation, it seems to me that the same goes for a servicing operation. Outside consultants are typically called in when a crisis erupts: figure out the scope of the problem, come up with a plan and fix it.

The only part left out, but strongly implied, is that the problem should have been fixed yesterday.

I've seen such occurrences. I've seen it when a lawyer threatens a class action lawsuit against certain servicing practices. And I've also seen it when a problem pops up just weeks before a regulatory exam is about to commence.

I've also seen the panic when some calculation is wrong, and the servicing manager fears making massive restitution for overcharging - all this discovered days before the outside auditors are due to arrive.

I was present once when a bank president found out about a major regulatory violation in his servicing department. This may seem strange, but his first call was to a lawyer. The president was in a state of near panic, and he literally promise the lawyer a blank check if he could fix the problem.

"You make this go away, and I'll give you a blank check. You fill in the dollar amount", the president said. The lawyer promised that he knew people at the OCC and that he would take care of it. Needless to say, the problem wasn't going to go away simply because the bank's lawyer was well connected, and the lawyer needed to tell the client this. In the end, the bank had to hire expensive consultants who analyzed several thousand loans and worked out a plan to fix the problem.

The real issue for servicing managers is to face problems head-on and fix them the right way, and to fix them early.

### *Ounce of prevention*

Having said that, the old cliché that an ounce of prevention is worth a pound of medicine could not be more true. I can't think of anything more cost-effective than the periodic checkup, the outside review and the audit to see, in advance of any blowup, if there are any problems.

The mortgage industry just came off a very wild refinance wave unlike any we've ever seen. Old loans were paying off faster than anyone could have imagined, and new loans had to be booked faster than anyone could have dreamed. The emphasis was on production, and unfortunately, not enough resources were given to overburdened servicing departments.

Let me put it another way: Try to remember the parties you went to in college. Do you remember how the bigger the party on Saturday night, the bigger the mess to clean up Sunday morning? The wilder the party, the more cigarette butts on the floor, the more half-eaten slices of pizza underneath the furniture?

The mortgage sector just had its wildest Saturday night party ever, and it's going to take a while to clean up.

The problem really gets back to what drives most mortgage companies, and that is production. During the past several years, all eyes were focused on production. It's hard to argue with that emphasis, but now that volumes have subsided, it's critical to examine the entire back office.

One study cited by Banc Investment Daily showed that even in times of normal volume, fixed-rate loans had an error rate approaching 10%, with adjustable having an error rate triple that. Further, this study apparently showed that loan payoffs had an error rate in excess of 25%.

These numbers seem awfully high, but the authors are very solid bank analysts, so I'll take them at their word. But even if error rates were only a half of what this study showed, or even a third, you can imagine how bad the level of mistakes were during the record volumes of the past two years.

Think of the workforce in 2002-2003. Think of the many people thrown into the production maelstrom so quickly that many never received proper training. After all, how many documentation clerks can actually figure out the interest rate based on an index of the last business day of the second month preceding the change date?

One amazing story is of the bank whose adjustable-rate mortgage documents stated that the "maximum limit on interest rate changes will not be greater than 0.00%" The zeros were meant to be a plug or placeholder until the real interest rate ceiling could be inserted. Alas, an untrained person never inserted the proper ceiling, and the notes were executed.

How would you like to be one of these borrowers? You'd have a mortgage with a rate that could never go above 0.0%. That's an incredible problem for the lender.

#### ***Confront problems***

Problems like these cannot be swept under the table. It is only a matter of time before they're discovered

- by borrowers, by auditors or by regulators. Even worse is when the mistake is discovered by a lawyer - the kind of lawyer that likes to do class action lawsuits.

Often a servicing department will want to bring it's own special auditors to focus on specific areas. A review and audit of the operation could confirm that you have the top servicing team you believe it to be. But it also might uncover some horrible problems.

If your auditors identify problems, it could take Herculean efforts to remedy them. One bank officer I know thinks there is 18 months worth of work ahead to clean-up the post-refi boom mess.

So what's important is to make certain that the servicing portfolio is being managed properly on an ongoing basis. What's important is to catch small errors before they're compounded.

When I got started in this business in the late 1970s, servicing was a sort of backwater of the industry. It wasn't given a lot of respect, and it didn't always attract the best and

the brightest.

Think about it. In the 1970s, the largest servicer in the nation was Lomas & Nettleton, with barely \$10 billion in loans!

Since that time, processes have become automated, and heads of servicing departments have become true asset managers. In fact, I would argue that servicing now attracts the best and the brightest. It's far too important a function for anyone less.

But as servicing portfolios have gotten bigger, the possibility for errors has increased dramatically. This has made it all the more important for the periodic but regular outside review.

Even the healthiest patient is wise to get a regular physical checkup.

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