AlphaCentric
The Future of Investing

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# AlphaCentric Insights

## *A Guide to Mortgage Services the Mortgage Backed Securities Eco System*

**In this piece we'll explore:**

1. **Who really takes your mortgage payment and what do they do with it**
2. **The truth about where your mortgage payment is really going**

*When a home buyer takes out a mortgage directly from a bank or via a mortgage broker, they typically assume the money is coming from a bank. Furthermore, they assume that when they make their mortgage payments, the money is going back to the bank to pay off their loan.*

*In reality, many mortgage originators sell the loan to someone else and even if they don't sell the loan, they rely on another firm to collect the mortgage payments, track things like taxes and insurance charges, and handle all the calls and inquiries from the borrowers. In addition, when loans are sold or packaged into mortgage backed securities, the loan servicers play a critical role.*

### Mortgage Servicers:

Mortgage servicers are responsible for the day-to-day management of mortgage loan accounts, including collecting and crediting monthly loan payments and handling escrow accounts. In today's market, loans and the rights to service them are often bought and sold. In many cases, the company to which payments are sent is not the company that owns the loan. If a borrower has questions about their loan account, they contact the mortgage servicer.

In addition to acceptance and recording of mortgage payments, servicers also calculate variable interest rates on adjustable rate loans, pay taxes and insurance from escrow accounts, negotiate workouts and modifications upon default, and conduct or supervise the foreclosure process when necessary. Banking organizations often perform mortgage servicing not only for mortgages that they originate but for others where they have purchased the servicing rights.

### Advance Financing:

Servicer advance financing facilities provide critical liquidity to mortgage loan servicers. In order to ensure continuity of payment to securityholders, mortgage loan servicers in RMBS transactions generally are obligated to advance delinquent principal and interest payments and to make certain servicing advances relating to the preservation and maintenance of mortgage properties (e.g. taxes, insurance, foreclosure costs, etc.). Advancing obligations can create liquidity challenges for mortgage servicers.

In other words, when borrowers stop paying their mortgage, servicers are contractually obligated to advance principal and interest payments to MBS investors.

**Servicer Revenues and Expenses:**

Mortgage servicing revenues include servicing fees net of guarantee fees, ancillary fees, and float earnings from holding Principal & Interest (P&I) and Taxes and Insurance (T&I) payments between collection and remittance. Servicing fees are collected by servicers as a component of the loan's note rate; therefore, servicers do not collect servicing fee revenue when borrowers are delinquent. The minimum servicing fees for GSE loans is 25bps and for FHA/VA loans it is 19bps.

Expenses include the direct cost-to-service, unreimbursed foreclosure and property expenses, allocated overhead, and the cost of funds (interest expense) fore servicing advances. In addition, additional expenses can accrue due to rep and warrant claims, compensatory fees, and servicing delinquencies on FHA loans.

For non-performing loans, the costs of servicing have increased since 2008 and these costs include the base direct and corporate costs of servicing any loan, costs associated with managing a default, and unreimbursed foreclosure and real estate owned losses.

# Mortgage Servicing Support Still Dynamic And Evolving

| US Residential Mortgage | Agency MBS | Non-Agency MBS |
|---|---|---|
| • Generally required to advance PITI if:<br>- P&I is deemed recoverable<br>- Stop Adv limits have not been met<br>• Advances are paid back – concern is short term financing<br>• If 25% seek forbearance, est. ~12bln/mo<br>• Policy makers have taken wait and see approach | • CARES Act<br>- Must offer min 6-12mos forbearance<br>- Suspend foreclosure & eviction for 60 days<br>• Servicers must comply<br>• GSE's can replace servicers | • Programs established after 2008 still in place<br>- Vary by servicer, with trustee oversight<br>- Many evolving to be consistent w/ CARES<br>• Many stopped advancing years ago on some mortgages. May see more if delinquencies grow<br>• Trustees can replace servicers |
| **Bank Servicers**<br>(53% of all servicing)<br>• Well-funded as a result of strict oversight & compliance + access to window | ❖ Little-to-no disruption to payments | ❖ Little-to-no disruption to payments |
| **Non-Bank Servicers**<br>(47% of all servicing)<br>• Lobbyists working to bring attention<br>• History with regulators<br>• Differing opinions:<br>- Some say adequately funded<br>- Some say potential for BKs<br>- Most agree help will be avail but some think reform strings attached | ❖ 40-70% of Ginnie serviced by non-banks<br>- No clear backup<br>- Ginnie announced PTAP and own servicer soon but will be "last resort"<br>❖ No plan announced for Fannie, Freddie, taxes, or Insurance yet | ❖ Some deals have bank as servicing administrators<br>❖ May see servicing changes |

Source: Barclays, Citi, KBRA, JP Morgan. Data as of 3/31/20. There is no guarantee that any investment will achieve its objectives, generate positive returns, or avoid losses.

## Acting Servicers:


For the most part, servicers can be divided into bank and non-bank servicers representing 53% and 47% of all servicing respectively.

Bank Servicer:

- U.S. and State-Chartered banks that serve as depository institutions, typically offering a full suite of consumer, investment, and financial products
- Mortgage operations, both origination and servicing , are often within the consumer lending division
- Historically, banks have retained mortgage servicing rights to maintain customer relationships
- Well-funded as a result of strict oversight and compliance.  Access to “window”

Non-Bank Servicer (Independent Servicers):

- Do not hold customer deposits
- Ability to specialize (i.e. default management)
- Can be publicly traded, independent, or private equity or hedge fund backed
- Subservicers (non-banks that perform all servicing functions for the servicer of record as a vendor)
- Lobbyists working hard to bring attention to space
- History with regulators – avoiding oversight

## Oversight and Regulation:

| Mortgage Servicer Type | CFPB | State Investor | Bank Regulators | FHFA, GSEs, GINNIE MAE, Investors |
|---|---|---|---|---|
| Non-Banks | X | X | N/A | GSEs |
| National Banks and Federal Savings Assoc. | X ($10b+ in Assets) | N/A | X | GSEs |
| State-Chartered Banks (Fed Members) | X ($10b+ in Assets) | X | FDIC, Federal Reserve | GSEs |
| State-Chartered Banks (Non Fed Members) | X ($10b+ in Assets) | X | FDIC | GSEs |

## Servicing Value Chain:

| | | | | | | |
|---|---|---|---|---|---|---|
| **Origination** | **Loan Example:**<br><br>• **4% note rate**<br>• **30-year fixed rate**<br>• **Conforming (agency)** | **Borrower:**<br><br>**Rate setting dependent on:**<br><br>• **Market rates**<br>• **Product type**<br>• **Borrower credit quality**<br>• **Borrower financials**<br>• **Originator or margin expectation** | **Down payment closing costs**<br>→<br>←<br>**Loan** | **Originator/Servicer** | | |
| Loan Example | Loan Example:<br><br>4% note rate comprised of:<br><br>• 3.50% coupon<br>• 0.25% guarantee fee<br>• 0.25% servicing fee<br><br>(sold through cash window) | Originator/Servicer<br><br>Gain on sale components:<br><br>• Loan sale proceeds<br>• Loan cost basis (including servicing value)<br>• MSR created upon loan sale | Loans<br>→<br>←<br>Loan purchase price $$ | Agency/Guarantor<br><br>The GSEs also have the role of master servicer | Security and Guarantee<br>→<br>←<br>MSB Purchase Price $$ | Investor |
| Servicing | Feedback loop to Origination:<br><br>• If the cost to service increases, service value decreases;<br>• If servicing value decreases, gain on sale decreases;<br>• If gain on sale decreases, originators may adjust rates to maintain margins | Originator/Servicer<br><br>Collects principal and 4% interest from borrower<br><br>Keeps 0.25% servicing fee as a compensation for servicing (MSR) | Principal and Coupon and G-Fee (3.75%)<br>→<br>←<br>Loan Guarantee | Master Servicer/Guarantor<br><br>Keeps 0.25% guarantee fee as a compensation for guarantee | Coupon (3.5%)<br>→ | Investor |

## Mortgage Bonds:

 Mortgage bonds offer investors protection because the principal is secured by an asset. In the event of default, mortgage bondholders could sell off the underlying property to compensate for the default and secure payment of dividends.

When a person buys a home and finances the purchase with a mortgage, the lender rarely retains ownership of the mortgage. Instead, it sells the mortgage on the secondary market to another entity, such as an investment bank or government-sponsored enterprise (GSE). This entity packages the mortgage with a pool of other loans and issues bonds with the mortgages as backing.

When homeowners pay their mortgages, the interest portion of their payment is used to pay the yield on these mortgage bonds. As long as most of the homeowners in the mortgage pool keep up with their payments, a mortgage bond is a safe and reliable income-producing security.

If a homeowner defaults on a mortgage, the bondholders have a claim on the value of the homeowner's property. The property can be liquidated with the proceeds used to compensate bondholders.

The mortgage-backed security turns the bank into a middleman between the homebuyer and the investment industry. A bank can grant mortgages to its customers and then sell them on at a discount for inclusion in an MBS. The bank records the sale as a plus on its balance sheet and loses nothing if the homebuyer defaults sometime down the road.

The investor who buys a mortgage-backed security is essentially lending money to home buyers. An MBS can be bought and sold through a broker.

## Bond Holders During Foreclosure:

Typically, mortgage servicers enter into contracts called pooling and servicing agreements with bondholders that spell out the servicers' obligations to manage the loans in the best interests of the investors. These agreements provide that the servicers be reimbursed by funds in the trust for all costs related to litigation and extra processing of foreclosures, provided they follow standard industry practices.

When houses that have been packaged into a mortgage bond are liquidated at a foreclosure sale—the very end of the foreclosure process—the holders of the junior, or riskiest debt, would be the first investors to take losses. But if a foreclosure is delayed, the servicer must typically keep advancing payments that will go to all bondholders, including the junior debt holders, even though the home loan itself is producing no revenue stream.

By delaying foreclosures, it means the subordinate bondholders do not get written down for a much longer period of time, and they keep getting payments.

## Excess Servicing:

Mortgage excess servicing is a fee based off of the percentage of the monthly cash flow of mortgage backed securities (MBS) that remains after the cash flow has been divided into a coupon and principal payment for the MBS holder.

A servicing fee is the percentage of each mortgage payment made by a borrower to a mortgage servicer as compensation for keeping a record of payments, collecting, and making escrow payments, passing principal and interest payments along to the note holder. Servicing fees generally range from 0.25% to 0.5% of the outstanding mortgage balance each month. The mortgage excess servicing fee typically goes to the servicer of the loan and may serve as a guarantee fee for the underwriter of the MBS.

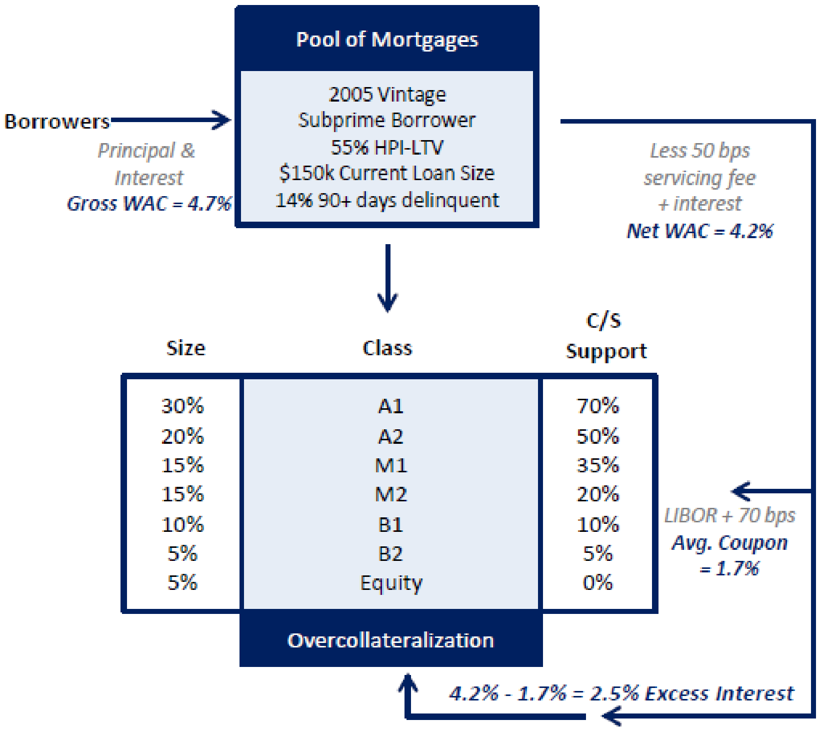
For example, in a typical MBS deal, if the interest rate on a mortgage is 4%, the MBS holder might receive 3.5%, the servicer of the mortgage receives 0.25% servicing fee and the MBS underwriter gets 0.15% This leaves the remaining 0.10% (4% - 3.5% - 0.25% - 0.15% = 0.10%) as excess servicing.

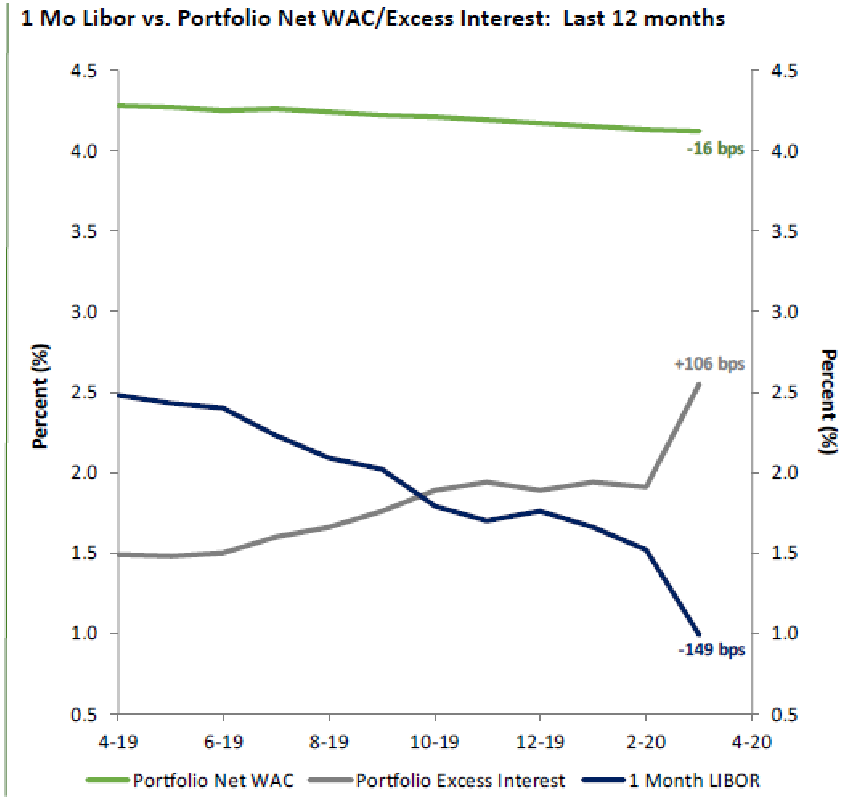
Mortgage excess servicing for MBS is subject to prepayment and extension risk. When excess servicing is priced, it is valued based on an estimate of how long the annuity will last. This must be estimated since it cannot be known for certain when a mortgage borrower might refinance or otherwise pay-off his or her mortgage. The value of excess servicing can change dramatically when interest rates change, because changes in current interest rates relative to the interest rate on the mortgage determine how long the annuity of excess servicing associated with that mortgage might last.

A mortgage serving spread is the amount of interest retained by the servicer and is regarded in part by the servicer as a form of reasonable compensation for the services that were performed. If there is a portion of a mortgage servicing spread that exceeds what could be deemed reasonable compensation for services performed, this is called the excess servicing spread and would represent a continuing investment in the interest portion of an underlying mortgage pool.

# Excess Interest Mechanisms Unique to Subprime Legacy Non-Agency RMBS

- Excess interest is the residual cash flow post scheduled payments to servicers/agents, tranche holders
- It usually is the greatest in subprime structures by design and enhances internal credit of deal structure
- Serves as first line of defense against losses from delinquencies and defaults, and potentially for repair credit support and write back losses.




Note: This example is for illustration purposes only and shows a simple cash flow waterfall as it relates to excess interest. Specific figures are made to mimic an "example" subprime deal structure. There is no guarantee that any investment will achieve its objectives, generate positive returns, or avoid losses.

**Important Risk Disclosures**

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