

The True Cost of Servicing

BY JEFF MOUHALIS

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You don't have to be an industry expert to know that servicers are under intense pressure — from shareholders and investors alike — to become more efficient and reduce costs. Yet few would suggest that they sacrifice compliance, security or customer service in the process. That's why it is critical for servicers to thoroughly understand the nature of their costs, identify those that might be advantageously reduced, and steer clear of cost-cutting measures that could ultimately increase costs or exposure over time.

Certainly, wholesale cost-cutting measures are rarely effective. If you exchange seasoned people for less expensive (less experienced) people, you often pay the price in higher error rates and poor judgment. If you cut corners to purchase less expensive equipment, you may experience higher costs in maintenance, support and replacement parts. If you reduce your reliance on a proven vendor partner to create in-house alternatives, you often pay the price in lost expertise, functionality and support.

This is not to say that these decisions are easy. Unfortunately, P&L statements clearly reflect decisions that show up as hard cost reductions — but they do not show the increased risk, decreased productivity or customer service impact of those decisions until much later. Sometimes the results of cost-cutting measures are profound, as in the case of an underfunded business continuity and recovery plan that fails to protect a firm when disaster strikes. Decisions like this may help the P&L look better in the short term, but they can ultimately sink a company.

Comparing Apples and Oranges

Part of the problem with evaluating cost-cutting initiatives is that it is an apples and oranges equation. Servicers might reduce costs in one area, but end up with a jumble of other costs they didn't anticipate, and perhaps don't know about because those costs are not

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aggregated or tracked. For example, if you change phone service providers to reduce your monthly cost — but lose an important business deal because of unreliable phone service — did you win or lose?

Of course, lost business opportunities are not tracked on the P&L. But that's not the only way an apples and oranges comparison can muddy the waters. What if you decide to end your contract with an outsource collections firm that costs \$60,000 per year — in favor of an in-house solution? You can hire a full-time collections person for \$50,000 (assuming fully loaded costs) and save \$10,000. Right?

Wrong. The cost of wages and insurance for the in-house person compared to the cost of the outsource collection firm is less. But there are other costs that are also incurred, including recruitment costs, training costs, vacation costs (to cover the employee's responsibilities), fully equipped office space, increased telephone charges and management costs to name a few. These costs are real — but because they are either incremental — like increased telephone charges or occur as events over time the way training does, they are not always captured to create a true cost comparison. Still, they should be.

To make decisions that can indeed reduce the cost of operations — without ultimately expanding the original cost environment — servicers must conduct a thorough analysis that includes both the obvious and the less obvious factors that will impact the bottom line over time.

The Servicing Cost Structure

There are plenty of reports that provide guidelines and industry averages for various cost categories. For example, a survey conducted by the Mortgage Banker's Association found that on average, servicers spend 50% of their budget for people. Something in the range of 17% of the budget is allocated for technology. That leaves 33% of the budget for everything else. Let's break this down in greater detail.

People

The cost of people across the servicing enterprise is dependent on many factors, including the number and size of the portfolios managed, type of loan instruments (high vs. low risk), area of the country served, etc. Nonetheless, the number of people required to appropriately service mortgage loans is largely determined by the operating environment and key decisions that are made by business and IT executives. Some of these include:

- The degree to which functions are outsourced or handled in-house.
- The range and depth of functionality provided by technology.
- The degree of automation vs. manual processes.
- The level of standardization vs. exception-oriented processes.
- The complexity and type of loan products serviced.

The number of people required by a servicer can vary dramatically based on these and other factors. However, the cost associated with the number of people employed is generally far more than just the cost of wages and insurance as discussed previously. When making decisions about cost-cutting measures, servicers must consider the full costs — not just the wage-related costs — of hiring and maintaining its pool of employees.

Hardware and Software Equipment

The cost of equipment can also vary widely, depending on the functionality and dependability that a servicer requires. Again, the cost of the equipment is not just the price tag plus taxes and shipping. In the case of the IT environment, it may also include the need for a secure, temperature controlled room — often with a raised floor; the cost of redundancy and downtime protection; people and equipment to maintain the hardware, etc. It also must include the security measures that are required to prevent unauthorized access to sensitive company or customer information, including firewalls and other protective measures as well as encryption capabilities and data storing and transmission protocols.

Business Continuity and Disaster Recovery

Servicers can sign a contract with an outside vendor to provide a disaster recovery site — but that is not the end to their costs. In this case, the cost of ongoing due diligence — including an evaluation of the partner's business continuity and disaster recovery plans, how often the plan is tested and how it is supported, developing a contingency plan in case the vendor goes out of business or is itself impacted by a disaster, etc., is also part of the cost equation. When servicers are operating an in-house organization, these initial and ongoing costs must be accounted for.

Risk Management

This area is critical to the servicer's ability to remain compliant with governmental rules and regulations, as well as to protect its operation from security breaches of every kind. In-house operations must develop extensive risk management strategies that enable servicers to keep abreast of the changing regulatory environment and accommodate it, they must stay on top of the fraud and data breach strategies used by security risk perpetrators, and they must invest in and maintain the tools and strategies to combat them. The costs to properly manage risk can be highly variable and steep, but this is typically an underfunded area. Servicers should focus their cost-cutting initiatives elsewhere.

Communication

In the servicing business, data is constantly moving from one person to the next and from one company to another. To the extent that manual intervention is required to initiate or facilitate this transfer of information, productivity is dramatically impacted and the likelihood of error is increased. This is further complicated by the dozens, sometimes hundreds of vendors that servicers deal with and that require data sets to perform the activities servicers want them to perform. Whether it is transmitting files, producing reports or managing network administration communications can be a very costly area for servicers. This is also an area where the aggregated costs are rarely understood.

