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Abstract

MORTGAGE SERVICING PORTFOLIO MANAGEMENT STRATEGIES

AN ANALYSIS OF US MORTGAGE INDUSTRY

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THE purpose of this study is to evaluate mortgage servicing from an economic perspective and further examine the challenges of these perspectives in managing mortgage servicing portfolio. The management strategies of mortgage servicing portfolio have become an increasingly sophisticated process along with the emergence of the secondary market for Mortgage Backed Securities (MBS). It requires a focused, comprehensive product packaging, professional and strategic product marketing, and skillful negotiations and closing of the deal. Our discussion concludes that the market value of a portfolio depends on aggressive marketing efforts that maximize competition to receive the highest bid. As the economic value varies from institution to institution, and even at the institutional level the economic value is expressed in terms of a range of possible economic scenarios rather than a single value. Therefore, it is extremely essential that the competitors in the mortgage servicing business understand thoroughly how to evaluate the economic value of components of their existing portfolios and of portions they are considering for purchase or sale. This requires not only the use of a sophisticated evaluation model but also the development of strategic assumptions and marketing efforts appropriate to the particular institution, as well as staying abreast to the changing dynamics of the market-place and actively manage their portfolios to take advantage, where possible.

The MBS market as we know it today can be traced back to 1970, when Ginnie Mae first guaranteed a pool of mortgage loans. The creation of Freddie Mac in 1970 helped to expand the market. Freddie Mac issued its first mortgage-backed participation certificates in 1971, and Fannie Mae issued its first MBS in 1981. There was little private-label issuance from 1977 until the early 1980s (Linda Lowell). Private-label MBS issuance began in 1977 when Bank of America engaged in the first private-label issuance of interests in a trust that held single-family mortgages. Many of the regulatory constraints affecting private entities were removed in 1984 with the passage of the Secondary Mortgage Market Enhancement Act of 1984 ("SMMEA") (Linda Lowell). SMMEA was intended to encourage private sector participation in the secondary mortgage market by, among other things, relaxing certain regulatory burdens that affected the ability of private-label issuers to sell their MBS. For example, SMMEA allowed state and federally regulated financial institutions to invest in privately issued mortgage related securities.

During the late 1980s, buying and selling mortgage servicing emerged as a vital part of the banking business. Mortgage originations were flooding in everywhere. Mortgage portfolios were growing to provide huge amounts of operating income. Until the passage of the Tax Reform Act of 1986 ("1986 Tax Act"), which recognized the Real Estate Mortgage Investment Conduit ("REMIC") structure with its beneficial tax treatment, most MBS were sold as "pass-through" securities. As discussed below, pass-through securities pay an investor principal and interest received from payments on the mortgage loans that are the assets of the trust. The payments on the mortgage loans are passed through the

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trust to the investors as they are made. However, even during the boom years in 1990s there were those who misused this instrument, who unwittingly hurt their business in the longer term. In banking industry, the obvious need for liquidity is a constant challenge. Mortgage servicing provides a steady, predictable and reliable income stream. As part of the contractual obligation of the mortgage bank to perform administrative duties such as payment collection, payment of property taxes, and payment of interest in exchange of a specific fee that provides income to the mortgage bank. Buying mortgage servicing generates the steady, reliable cash flow everyone needs. In order to streamline and tailor operations to produce maximum economies of scale, portfolio managers need to adjust the mix of loan types being serviced.

We intend to present a comprehensive analysis of changing paradigms of mortgage servicing industry in the U.S.