



Master Servicing: An Investor's Best Friend

In his book, *Freakonomics*, author Steven Levitt proposes that complex phenomena can be understood by finding the right perspective. The concept is that if morality represents how we would like the world to work, economics represents how the world often actually works.

Those in the mortgage industry know that for both simple and complex phenomena, economics is a main factor that drives decision-making. A perfect example of this reality is master servicing, where industry investors use an economics lens to ascertain and benchmark performance and experience vs. anticipated returns.

In the best of times, the value of master servicing is often overlooked by most members of the mortgage community. After all, in prosperous conditions, there is generally more than enough cash flow to protect investors. However, during times of distress—and when there is simply not enough cash flow to cover a deal—the need for a stable, efficient master servicer can equal the value of a qualified servicer. This does not seem like a complex phenomenon requiring an economics professor to explain if one understands the comprehensive process of master servicing.

Put simply, master servicing equals transparency, security and stability for a mortgage transaction. With a primary focus on timely and accurate distribution of funds, master servicers provide liquidity to transactions by performing the role of advancing agent. In the oversight role, master servicers aggregate primary servicer data, reconcile funds and ensure the successful disposition of delinquent loans.

The master servicing process

With several primary servicers often servicing one transaction, the aggregation of both data and cash flow can become a complex task. Master servicers are experts at making sure this process moves quickly and efficiently. They collect loan data from primary servicers, calculate the expected principal and interest payments that investors should receive, and reconcile any differences with the servicers (i.e., shadow servicing) to ensure payment accuracy.

Another key master servicer responsibility is managing default timelines, ensuring that all timelines are met and providing approvals for processes such as loss-mitigation workouts as necessary. The objective here is to minimize losses to investors.

Additionally, master servicers may review expense claims made by primary servicers during stages of default as the ser-

vicer maintains and sells defaulted properties or reduces the severity of the loss. The master servicer's responsibility in this case is to determine if a claim is within typical costs allowed by the servicing agreement, and either pay out the appropriate expenses or deny the claim.

The master servicer also may become involved in the selection and coordination of a special servicer. Finally, the master servicer coordinates the transfer of servicing in the event of a servicer default resulting from insolvency or inability to service the loan as promised.

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The importance of master servicing in today's mortgage climate

As the mortgage climate has evolved recently, master servicers are needed now more than ever. Nontraditional loan products new to the marketplace, such as payment-option adjustable-rate mortgages (payment-option ARMs), interest-only loans and dual-amortization loans, have caused some master ser-

vicers to change the way they operate. More important, these products have made investors realize just how important the role of master servicing is to a business.

As loan products become more complex, so do deal transactions, because street firms are increasingly trying to structure their risk. Nontraditional products resulting in multifaceted deal structures require sophisticated master servicers to accurately calculate bond payments for investors and provide transparency in reporting. As such, master servicing is a growing and more heavily relied upon component in many deal structures.

In an up market, investors experience strong cash flows. As a result, they aren't as focused on scrutinizing how servicers spend and remit money. In the current market, however, with delinquencies on the rise and credit risk being exposed, investors must ensure that their cash is being handled properly. Master servicers can ensure that principal and interest (P&I) are being remitted correctly and that no additional or unnecessary expenses are incurred during the claims process.

The increased number of delinquencies also highlights the need for a master servicer to oversee default functions, protecting the investor's assets.

Choosing a master servicer

It is imperative to look for strengths in the following five areas when considering a master servicer candidate:

- customer service;



- breadth of products and deal structures;
- controls;
- ratings by industry experts, such as New York-based Moody's Investors Service, Fitch Ratings and Standard & Poor's (S&P); and
- experience.

Customer service encompasses having a client-centric business model, in which clients can easily access loan-level detail and deal-level data, including loss, prepayment and delinquency information. Master servicers act as investor advocates, monitoring servicer default activities and providing counsel to issuers if standards are not being met. Finally, superior customer service also involves being able to offer customized solutions, such as base services plus a la carte services, as well as flexible solutions based on client needs.

The breadth of product and deal structures is an added component when considering a master servicer. The ideal master servicer can handle the full credit spectrum of loans, including prime, nonprime, scratch-and-dent and distressed. Similarly, the ability to master-serve a variety of loan products—such as interest-only, payment-option ARMs and hybrid loans—also is beneficial.

This service is valuable and can be customized and exported to international mortgage markets, leveraging existing systems and expertise. For example, Residential Funding Company (GMAC-RFC), Minneapolis, has developed the capability to master-serve Canadian weekly and bi-weekly amortizing loans. Additional master servicing advantages come in the form of selling prepayment charges as certificated interests and using derivatives within deals.

Inherent in providing exceptional customer service and the ability to master-serve a wide variety of loan products and deal structures is a commitment to transparency. A successful master servicer is committed to making important information available to investors through various means, including a consistently updated, "live" Web site and trained associates who are both knowledgeable and accessible.

Transparency of data is a distinguishing factor among master servicers. By providing investors with information to make informed decisions, a good master servicer can ensure loyalty and investor satisfaction throughout the years.

Another factor in determining the quality of a master servicer is the emphasis placed on internal and external controls. One such control is reconciliation of data discrepancies to ensure accurate bond payments, continually striving for a zero-percent error rate and consistently tying out loan-level data to the deal.

Equally important is a secure environment—one in which data are password-protected and in which only the investor and the master servicer can view the data. Finally, Regulation AB demands that all qualified master servicers be compliant with Reg AB, meeting specific regulation guidelines. In compliance with the Sarbanes-Oxley Act, it is also important that master servicers have the proper controls to ensure that financial reporting is accurate and that they can certify that accuracy.

A final piece in the puzzle when choosing a qualified master servicer is considering its ratings and experience

level. Selecting an experienced master servicer provides numerous investor benefits likely not realized when dealing with a newer, less-experienced player.

Ratings are based on a master servicer's ability to oversee primary servicers, and at the same time remit payments and data to investors in mortgage-backed securities (MBS). With the increased need for qualified master servicers, new players are being proactive to secure ratings with one or more of the ratings agencies.

GMAC-RFC maintains top ratings from all three agencies (Moody's, S&P and Fitch) in order to meet the needs of its own securitization business as one of the industry's largest issuers, as well as to be positioned to support market needs regardless of rating agency selection.

Commitment to investors

A master servicer's ultimate role is that of an investor advocate. By focusing on investors, master servicers comply with all deal contracts and make sure investors do not have to bear any more losses or expenses than absolutely necessary.

As a reporting agent, accuracy remains the master servicer's primary focus. If reporting is not accurate, investors will eventually lose confidence. The connection between accurate reporting and accurate calculations is a strong one, as qualified master servicers must be able to calculate payments owed to investors as well as deal performance, to provide in-depth, accurate reports to investors, trustees, bond insurers and other bond participants involved in the deal.

A strong master servicer also provides convenient data access so that investors can make informed investment decisions.

Additionally, if and when servicers begin cutting costs, master servicers step in to make sure integral processes are not being changed and that modifications made to the operation will not be detrimental to investors in the long run.

A final commitment to investors comes in the form of efficiency. It is in an investor's best interest to choose a master servicer capable of handling most, if not all, aspects of master servicing. For example, some master servicers may act only as calculating agents and not provide oversight, while others may not manage default timelines. If a multifaceted master servicer is not chosen, this work will likely be outsourced to another company, resulting in multiple fees and additional deal complexity.

Final thoughts

In today's challenging mortgage market, many companies are developing an approach and choosing partners to protect their valuable interests. Investors have two fundamental choices: don a coat of armor and take hits from lack of oversight and/or inaccurate remittances, or hire a master servicer to play the role of guardian to oversee, counsel and manage all aspects of the deal structure. In this market, prudence and experience suggest making the choice of aligning with an experienced master servicer an easy one.

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