

The Changing Landscape OF COMMERCIAL SERVICING

for years, the commercial mortgage servicing marketplace has been characterized by a relatively small number of companies holding the lion's share of the market. However, as the lending landscape changes, a growing number of nontraditional players (community banks and credit unions) are recognizing commercial mortgage servicing as a viable revenue generator, and either have begun to establish or enhance existing commercial servicing operations. ■ Some background would be helpful here on why banks and credit unions may be looking at commercial loan servicing. For starters, the personal savings rate for Americans in 2006 was a *negative* 1 percent—the lowest savings rate since the Great Depression. This decline of core deposits seriously affects the ability of community banks and credit unions to fund loans. ■ The challenge for financial institutions, therefore, is to find new funding means by supplying new fee income through extended relationships with existing customers. Offering residential and commercial mortgage loan servicing allows banks and credit unions to do both. ■ Adding these elements,

BY DAWN GIBBS

There are emerging business opportunities in the field of servicing commercial mortgages that small to medium-size players would be smart to consider.

however, requires some due diligence in order to ensure proper training of employees and the layout of an effective technological infrastructure. "There is a whole body of knowledge and skills required when servicing loans," says Jamie Woodwell, senior director of commercial/multifamily research at the Mortgage Bankers Association (MBA).

"There are a lot of intricacies in the servicing area, which revolve around taxes, escrow accounts, technology, yields, maintenance and assumptions," says Woodwell. Up until now, there have not been "a whole lot of firms that originate and service," he explains.

Traditionally, large-scale mortgage companies had servicing operations. But now there is some further blending—and some more specialization—taking place in the industry.

Residential mortgage lenders that presently compete for origination transactions are now also seeking to grow their business by offering a commercial loan-servicing component. At the same time, smaller loan originators, such as community banks and credit unions, are also moving into commercial servicing as they seek ways to remain competitive in the present changing environment. These new entrants bring a whole new wave of competitors into the commercial servicer space.

The changing landscape

During the next five to 10 years, the \$12 trillion real estate finance industry is projected to undergo dramatic changes in several areas, including the economy; capital markets; borrowers, products and processes; and technology. That is the conclusion drawn from a report prepared by the Council to Shape Change, a Washington, D.C.-based think tank facilitated by the MBA and made up of 19 industry experts. The group was charged with the mission of generating an outline for the mortgage arena's future.

According to the Council to Shape Change, the industry will see many fundamental changes over the next decade. Among the council's predictions for the future of the industry are:

- An increasingly consolidated industry, with real estate finance processes dispersed into many smaller components that can be automated and outsourced.

- Large, integrated financial services companies demonstrating the facility to cross-sell a diversity of financial products to existing customers.

- Borrower demands forcing changes in products, processes, channels and work force.

- Regulations, in all likelihood, that will become increasingly stringent for both residential and commercial mortgage lenders.

Some of those changes are already beginning to take

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shape. "Across the origination and servicing side, we see increased consolidation," Woodwell points out.

So, even though large firms will gain market share—particularly in retail originations and servicing—consolidation will produce opportunities for smaller, more agile organizations. "Without the expensive infrastructure and red tape of their bigger competitors, the best of these firms will be capable of moving quickly on niche prospects," suggests Woodwell.

Commercial mortgage servicing as an entry point

Mortgages are an integral part of the financial services industry and, in many cases, are no longer viewed as a separate product group. The Council to Shape Change asserts that servicers are experiencing a change in outlook as well.

"Servicing is increasingly being viewed as a profit center, not just a cost to be minimized," the council's report states. "There are significant opportunities for servicers to build on their relationship with the borrower."

The ability to attract and retain customers, whether consumer or business, has become increasingly more complex as financial institutions fight for every deposit they can acquire. Consumers and businesses alike can now easily secure loans and investment accounts from a variety of sources, forcing financial institutions to focus their attention on building relationships and adding revenue growth. As a result, financial institutions are beginning to treat the servicing group as another way to enhance and extend their established relationships with borrowers.

At credit unions, in particular, mortgage lending is a key driver of member acquisition and retention. Real estate loans, which represent 49 percent of the total credit union loan portfolio, account for most of the credit union industry's loan growth.

During the first six months of 2006, first-mortgage loans experienced the greatest dollar increase of any loan segment at \$8.34 billion (5.75 percent), followed closely by "other" real estate loans at \$5.84 billion (7.95 percent). However, a significant deceleration in economic growth in 2007, aided by weakening deposits, foreshadows a rough road ahead for lending.

A critical loan-servicing entry point for credit unions and banks could be in commercial mortgage origination and commercial mortgage loan servicing. Smaller banks and credit unions see commercial real estate lending as one of their best opportunities to battle successfully with larger national lenders.

This is particularly true since commercial real estate has surged in recent years after several down years. In the

mid-1990s, 15 percent to 20 percent of federally insured banks had what regulators consider a “heavy load” of commercial real estate loans. In 2005, the commercial debt load for federally insured banks was 40 percent, according to the Federal Deposit Insurance Corporation (FDIC). “Commercial real estate has been performing really well in recent years, which has attracted more investors in the market—and that has drawn more banks and credit unions in,” says Woodwell.

“Commercial real estate is big business, and servicing income can be very lucrative for credit unions,” says Lyndora L. Taylor, director of real estate services at OSU Federal Credit Union in Corvallis, Oregon. “Credit unions are all about the member, and providing additional services to business members is one more way to enhance the total member relationship,” she says.

OSU Federal, which has \$432 million in assets and 51,000 members, services all aspects of commercial mortgage loans after consummation of the loan, including payment processing, escrow processing, billing management, accounting, reporting and beyond. “We entered into the total realm of commercial lending [origination and servicing] at the same time,” she says. “We are fairly new to the business—just over three years.”

The competition is fierce for those commercial real estate accounts. Financing sources include mortgage banking firms, banks, credit unions, savings-and-loan institutions, regional banks, insurance companies and private investors. However, it may not be as difficult as in residential servicing, “where there seems to be more subservicers and large aggregators vying for the residential servicing business,” says Taylor.

Several commercial niches might offer other opportunities:

■ Two surveys conducted in 2006—one for small-balance commercial brokers and one for lenders—offer an interesting vantage point. Both surveys, conducted by the *Scotsman Guide*, Bothell, Washington, a resource for mortgage originators, and the independent research firm Boxwood Means Inc., Stamford, Connecticut, examined the small-balance commercial mortgage market, which comprises commercial and multifamily loans that are less than \$5 million.

Some of the surveys’ key findings revealed there was a record-setting \$134.4 billion in small-balance commercial originations in 2005, and the small-balance commercial loan market is continuing to grow. The surveys found that residential mortgage brokers are successfully migrating into the small-balance commercial mortgage arena, and lenders are relying on brokers and intermediaries for the bulk of their originations.

■ The securitization market also gives financial institu-

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tions more vehicles in which to place their funded assets, says Woodwell, such as with commercial mortgage-backed securities (CMBS). The selling of CMBS servicing rights, for instance, embodies a key piece of the income produced from the origination and securitization of commercial mortgages. “[CMBS] has been a major force in the industry at large, and the servicing industry [in particular],” adds Woodwell.

However, the commercial loan servicing business is consolidating, as mentioned earlier. Concentrating CMBS servicing rights among a small number of companies is alarming to some observers, while others believe it is an opportunity. The collateralized debt obligation (CDO)—a market that New York-based Celent LLC estimates at close to \$2 trillion—also is seen as a ripe securities area with opportunities for servicing.

Technology available for commercial mortgage servicing

The structure of mortgages themselves and the investor component have become more complex. “The real estate finance industry is a bridge between

borrowers and investors,” the Council to Shape Change report states. “Real estate finance customers, both investors and borrowers, will demand increasingly specialized products.” That, in and of itself, requires more areas of expertise and more proficient support services, which the market will accommodate.

TowerGroup, Needham, Massachusetts, believes that lenders must get serious now about upgrading their technology in order to make the lending process more effective. This means starting to shred those paper-based and manual processes in favor of electronic processes.

“Institutions can continue to stumble along with two- to three-year timelines for new-product development. Yet they will find themselves increasingly unable to meet changing market needs, continuing to push stacks of paper through origination centers while finding themselves left behind the competition,” says Craig Focardi, research area director of the consumer lending practice at TowerGroup.

According to the Council to Shape Change report, while separate programs needed to service the highly customized products will occur, it could be a decade before loan administrators and larger organizations will be able to abandon their huge legacy systems to handle those new requests.

Taking advantage of opportunity

The market can expect to see fewer and fewer mid-size players in the future real estate finance landscape. The Council to Shape Change’s vision is for the industry to increasingly

resemble a barbell with some very large players at one end and many small players at the other end, with not much in the center.

“[The council] expects a relatively small number of large specialized players and a large number of smaller participating firms,” points out Woodwell.

For financial institutions looking to grab a bigger share of wallet from existing customers or more products per customer from existing customers, including investment and business accounts, mortgage servicing and commercial mortgage servicing provide an excellent opportunity. However, in this case, too much hesitation could be costly. If financial institutions do not pursue this business quickly, they run the risk of leaving funds on the table for new competitors.

Mortgage brokers who compete for loan originations are already seeking (and in some cases, being forced by the market) to expand their business by also offering a loan-servicing element. Many are facing difficulty selling their loan pools in today’s second-

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ary market, and some brokers are now moving into what is known as “interim servicing”—which, in some cases, is leading to more traditional, long-term servicing.

Generally, any organization providing loan origination that adds a loan-servicing component—or a commercial loan-servicing component—also adds value to its business model for consumers, and attracts business partners for securities issuers and real estate investment houses.

Real estate finance organizations and others that are able to devise strategic models and systems that are adaptable to the changes that lie ahead should be better prepared for customers that are more demanding, as well as the opportunities they present. **MB**

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