What are *you* doing to mitigate operational risk?

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We got together with Hampton Mortgage Servicing (HMS) heads Daniel Maycock and Daryl Gorham, to produce a guide to loan servicing in bridging and look at why this third-party option, aimed at bolstering lenders' infrastructures and streamlining operations, deserves a closer look

WHAT ARE THE VARIOUS ROLES WITHIN A LOAN SERVICING TEAM?

The role of an outsourced servicer is to ensure the smooth running of customer management and back-office operations following the completion of a loan. Within servicing, the functions can broadly be divided into three distinct teams:

- primary servicing: this covers day-to-day operations, dealing with customer enquiries or communications, processing interest payments (depending on the type of loan) and redemptions. Essentially, these are administrative roles that are business critical and fundamental to the success of the routine management of the company
- special servicing: liaising with borrowers to work out delinquent loans and arrears management. Typically, this is where loan servicers can add significant value to lenders by utilising their experience and expertise to achieve the best outcome and possible performance of the loans
- loan administration: this includes tasks such as statement production (including redemption documentation) and updating customer details.

The loan admin team also ensures the validity of the data put into HMS' proprietary portfolio analytics platform. This tool produces in-depth data visualisation to lenders' funding partners and is an area that is receiving increasing interest as funders are eager to consume data to manage their risk exposures.

WHAT HAPPENS AND WHEN

Most lenders are likely to mention a servicer's involvement with the management of the loan—which begins once the it has been underwritten and funds released—at an early stage. At this point, compliance checks are undertaken to ensure that the lender has completed all relevant AML/KYC requirements and that the associated documents are completed. Following that, HMS works with the lender to obtain client information, utilising technology to reduce any potential margin for error, before setting them up in its loan management system. Welcome letters are then issued to clients to confirm that it is the lender's approved servicer and, depending on what level of service has been agreed, sets out the process for collecting interest payments, redemptions, and document requests.

WHY IS BRIDGING NOW SEEN AS A PARTICULAR AREA OF OPPORTUNITY FOR THIS TYPE OF SERVICE?

HMS was launched in 2014 to provide servicing for other types of specialist loans, and the bridging business grew organically from client referrals. Although it does already work with a handful of bridging providers, it is an area that HMS has only recently started to actively look at, because of the sector's maturing infrastructure requirements.

The decision to specifically focus on bridging at present stems from the view that the market is reaching an inflection point in its development, as institutional investors that are seeking enter the sector. With the base rate at an historic low and other more mature real estate credit markets having a glut of credit available, distorting valuations, bridging offers near double-digit yields. As more move in to the 'safer' end of private debt, the market becomes more competitive and yields decrease, meaning that those investors seeking higher returns with a higher risk tolerance will naturally begin to move into riskier markets, such as bridging.

While the returns could be very attractive, institutional investors will naturally have concerns around credit risk, but *operational* risk also represents a key hurdle to overcome prior to deploying capital for those who are naturally risk averse. What HMS has observed in discussions with various market participants (both direct potential clients, as well as many of their advisers) is that, as an industry, much of the loan servicing done by smaller lenders is extremely manual and, in many cases, run on Excel spreadsheets—with little in the way of oversight and implementation of controls, policies and procedures.

Establishing a sound operational framework can act as a distinguishing factor between competing lenders and prove attractive to prospective funders. A system like HMS' can provide the comfort that controls and procedures are in place and being followed, mitigating risk for investors who have full visibility of this through comprehensive and transparent reports.

INCREASING TRANSPARENCY FOR FUNDERS

HMS' administration system gives funders the ability to understand the composition of the lender's loan portfolio and review key underlying metrics in a dynamic dashboard format. This additional transparency of data means that funders are able to better manage their risk and compliance exposures but, equally, bridging lenders are able to demonstrate the quality of their deal origination and underwriting processes to secure further credit. Exposure+, an analytics platform that overlays the core version, is based on the latest SaaS technology and is fully customisable to meet the needs of lenders. Along with the standard set of reports that a lender would want to see (exposures by geography, sector etc), it has the ability to cater to lenders with multiple funding lines whose books can be analysed in different ways and reported upwards.

INTERSECTION WITH PROPERTY RECEIVERSHIP

The purpose of a loan servicer is to remove as much operational burden as possible from the lender, allowing them to focus on their primary business objectives. One way in which servicing demonstrates its value is when it comes to receivership and debt collection, aspects that can either be white-labelled or fully outsourced. By efficiently pre-packing evidence ahead of possession orders, utilising existing relationships and preferential rates with legal firms, and dealing with the borrowers directly, distance is created between lender and client—and reputational damage can be limited. Proactivity in this area has undoubtedly assisted during the past few months, as servicers are often aware of problems and can address them with the lender before they come to a head, resulting in forbearance.

HMS adopts a partnership approach to borrower management, ensuring that it extends the same due care and attention that the borrower would experience if dealing with the lender directly. During the onboarding process with new lenders, it spends a lot of time with the principals to really understand the company's culture and embed this within its own standards and best practices for managing customer relationships.

This exercise is key to really understanding the lender's client base and thresholds of tolerance when loans go into default and capital balances are at risk. HMS believes that its experienced specialist debt collections team has consistently demonstrated its ability to improve the performance of delinquent loan books on behalf of lenders.

Explained

THE UPSIDES

Whether in the pre-launch phase or early stages of development, the choice for any aspiring lender is whether to keep servicing operations in-house or to outsource. In the mainstream lending markets, it doesn't necessarily make sense to outsource operations, given the sheer volume of business lines and system integrations required. However, in the world of specialist lending, and bridging in particular, it adds value.

Regardless of size and the length of time the business has been operating, lenders working with HMS, for example, benefit from institutional-grade infrastructure: sophisticated proprietary loan management systems, an experienced team with specialist knowledge, and robust compliance policies and procedures from an FCA-regulated servicer.

In addition, there is support for when lenders want to scale up, with resources deployed accordingly to ensure maximum efficiency. Perhaps most importantly, it is said to be much more cost efficient when compared to building an in-house servicing function.

It is HMS' opinion that bridging lenders should focus on what they're good at: originating and executing bridging loan transactions, and that their recruitment should reflect those priorities. Hiring support staff, such as experienced loan administrators and case managers, means that those salaries are fixed balance-sheet costs. That, coupled with the prospect of further recruitment as the business grows and significant investment in software, makes it start to look like a model that is difficult for a nascent lender to sustain. Through a servicer, a lean approach can be followed, combining experience, regulation, systems, and staffing for a single cost.

MAINSTREAM POSSIBILITIES

Traditionally, outsourcing servicing in the bridging space could have been seen as only applicable to the select few lenders with sizeable balance sheets to withstand the associated cost of going through the exercise. This was possibly connected to significant consolidation about a decade ago—owing to changes in regulation and technology—that left only a handful of very large outsourcing players who were deemed unsuitable for SME lenders.

HMS wants to turn that model on its head and is intentionally looking to partner with lenders at the early stage of their development cycle, or those that have been running for some time but are now ready to take the next step and begin to attract institutional levels of capital. It believes that this segment is chronically underserved by the incumbent outsourcers; many lenders it has spoken to have never considered outsourcing as a possibility for loan books of less than £100m in size.

FOR WHOM WILL THIS *NOT* WORK?

HMS considers that 'old school lenders'—those with a handful of established client/broker relationships and a small team of experienced senior professionals who are very comfortable without having a major growth trajectory—may not seek out the help of a loan servicer.

Most bridging lenders HMS has engaged with thus far have a strong desire to grow their loan book and partner with a provider that is flexible as the business scales and increases in sophistication, providing support through the various stages of its lifecycle.

THE 'CREEP' OF REGULATION

Working with a regulated specialist servicer works towards future-proofing a lender against the inevitable regulatory scrutiny that is widely considered to be on the horizon. In bridging, you have the somewhat unusual setup in which some loans are caught under current consumer credit regulations, while others are not. In addition, there is the unfortunate negativity surrounding unregulated lending businesses in the mini-bond and P2P markets, further piquing the FCA's interest in the sector.

Whether a lender offers regulated and/or unregulated loans has no impact on the way HMS services them; it is duty-bound to ensure that it applies the same standards of servicing, and having these in place can prove to be a significant value-add for unregulated lenders when speaking to prospective funders.

As a broker, a significant amount of comfort can be gained from knowing that an FCA-regulated entity is involved in their client's processing, ensuring compliance and acting as a third party in a governance capacity.

WHY NOW?

In many cases, the pandemic has presented businesses with the opportunity to take stock and assess their models in order to become more efficient wherever possible. Reports of record lending may also spur lenders on to consider third-party providers.

HMS believes that, with the extensive nature of the initiatives introduced by the government, it's very possible that we are yet to see the true recessionary impact of Covid-19 and, where lenders have been flexible and patient with borrowers during these unprecedented times, there will come a moment when this forbearance will end. The skill and experience of a regulated, established servicing partner will yield significant benefits to lenders in generating results on delinquent loans. ■