Loan Servicing Fees: Why Do Some Lenders Have Them and Others Don't?

Private money lenders and hard money lenders typically have a choice of two management models: outsource the management of the loan servicing or hiring a team and managing the loans in-house themselves.

Outsourced management tends to be low cost, but requires active engagement to get good value.

The outsourced management model is one where the money lender designates third-party managers to manage collections, late notices, insurance and property tax audits. However, if these private lenders only receive upfront brokerage fees, they may be incentivized to do "bad deals" they would pass on if they were personally invested. Additionally, because these parties only have one "bite at the apple," they will often charge higher broker or origination fees than a full-service company would.

Only allowing a broker or private lender to be paid once means that underwriting is potentially overlooked, as restructuring a bad deal into a good deal means they may lose their loan income stream altogether. What this ultimately translates into is more risk to the investor in a variety of ways. For example, an investor may be exposed to riskier borrowers, higher loan-to-values (LTVs), and riskier asset classes, such as land, construction, and distressed properties. While exposure to these types of risk are inherent to hard money loan investments, investors should be aware of the risk profile for every investment and ensure that the expected return is correspondingly higher to account for those risks. Additionally, investors should be aware of how big of a risk they are taking, and if that aligns with their desired risk profile. The only way to ensure that an investor is accepting the right risk is for them to take a more active role in underwriting the loan and asking outsourced management to perform more extensive due diligence.

Outsourced servicing is a low-cost solution, but can result in higher delinquency rates and subpar returns if an investor is passive.

After funding a loan, outsourced management turn to large, low-cost providers, known as "subservicers," or subcontracted servicers. Subservicers help facilitate regular reporting for investors of the private money lender, and facilitate the monthly payment process if an investor is one of many participants in a loan opportunity. Subservicers charge a flat nominal fee to set up a loan, and then continue to charge a flat fee per month collecting borrower payments. However, in the event a borrower is delinquent, the convenience typically ends there. As the saying goes, "You get what you pay for."

Subservicers inevitably do a subpar job, especially on difficult to manage loans, which if used in tandem with outsourced deal flow and underwriting, can lead to disastrous

consequences for the investors that were placed into the deal by the private money lender. Subservicers do not monitor insurance or property tax payments, nor do they make any effort to ensure that delinquent borrowers pay their balances in a timely manner. They often allow default periods to run longer than contractually stated, property taxes to be delinquent, and insurance policies to lapse on collateral property. More importantly, subservicers will charge the investor, regardless of whether payment is received or not, so there is a lack of incentive to collect payments.

Lastly, subservicers provide inadequate customer service to borrowers and lenders. Neither party has a primary point of contact, so it can be difficult to resolve problems that arise. Any one of these concerns can expose a trust deed investor to exceptional amounts of risk, eroding their returns or even outright exposing them to complete loss of principal.

Full service management prioritizes the interests of investors, but requires proper due diligence selecting a manager.

Finding a private money lender that manages loan servicing in-house can be a difficult task for any investor. Most private money lenders that manage mortgage pools tend to do their loan servicing in-house. This is a great opportunity for investors to consider this option when looking for loan opportunities. Critical questions to ask a potential mortgage pool manager or private money lender are numerous:

- What type of loans do you do? First lien or second Lien?
- Did you originate this loan internally, or are you paying a third-party broker?
- What is your compensation structure? How do you get paid?
- Do you have any “skin in the game” with this deal, following funding?
- Who does your underwriting? What is their background?
- What are your typical LTVs? Are there any reserves built into the loan?
- What is your average default rate for the loans that you originate/service?
- How many loans have you originated in the last year? What percentage has gone to foreclosure?
- Do you monitor and advance property taxes? What about insurance?
- Do you sell your notes, or do you hold them to maturity?

Depending upon the investor’s risk appetite, this line of questioning will likely serve as an adequate filter to find the right private money lender that matches up with their investor profile. The fewer the services a manager provides, the more an investor should reconsider sub-service models. Mortgage pools can produce a significantly improved experience, depending on your priorities. How active does the investor want to be in staying in front of borrowers? If you’re using a loan subservicer to handle individual deals, you will need to stay in touch and spend time tracking the deals. If you do not have that kind of time, or the systems necessary to do it professionally, find a private money lender that has the full suite of services, and a consistent track record.

The investor will need to weigh the tradeoffs between the manager's fee structure and the return earned.

The private money lender should provide a track record showing the services rendered to the investor, and demonstrate that they perform more than adequate underwriting and efficient collection payments, mitigating headaches and heartburn. In short, their attitude should be to treat each deal as if it was their own money at stake.

For example, at Socotra Capital, we generate our own deal flow, underwrite all our loans in-house, and provide full servicing on all of our loans for a flat servicing fee of 1.25%. Our loan portfolios typically run 99%-100% current, with only a few foreclosures in the trailing 36 months. We have our own money in each of the funds, and invest alongside our clients on individual deals. We are your partner through and through.

To learn more about how Socotra Capital can help you grow your real estate investments, contact us today!