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Federal Housing Finance Agency
Fourth Floor
1700 G Street, NW
Washington, DC 20552

RE: Servicing Compensation Discussion Paper

Dear Sir or Madame:

The Independent Community Bankers of America (ICBA) welcomes the opportunity to comment on the Joint Initiative on Mortgage Servicing Compensation issued for public comment by the Federal Housing Finance Agency (FHFA). The FHFA has directed Fannie Mae and Freddie Mac (the "Enterprises") in coordination with the Federal Housing Administration (FHA) and the Department of Housing and Urban Development (HUD) to consider alternatives for future mortgage servicing structures and servicing compensation for single-family loans. One proposal would establish a reserve account within the current servicing compensation structure. The other proposal would create a new fee-for-service compensation structure. The FHFA has issued a Discussion Paper to propose and seek comments on the two new mortgage servicing compensation structures.

ICBA strongly urges the FHFA not to go forward with either of the proposed changes discussed in the Joint Initiative on Mortgage Servicing Compensation, as neither will accomplish the stated goals for the changes. We are greatly concerned that the proposals will increase consolidation in mortgage origination and servicing as small and mid-sized servicers leave the business as servicing fees for current loans are cut and are insufficient to cover their costs to service. New servicing requirements are being imposed on the industry and more changes may come. Servicing fees should not be changed in this environment where servicing requirements are subject to change. Finally, given the final resolution of the Enterprises has not been settled, we believe making any major change in the servicing fee structure would lead to further disruption in the mortgage market, possibly increasing the costs to taxpayers of supporting the Enterprises. ICBA offers the following additional comments at this time and would be happy to provide the FHFA additional information about our views.

Goals of the Initiative Will Not Be Achieved

The FHFA states that the goals of the initiative are to improve service for borrowers, reduce financial risk to servicers and provide flexibility for guarantors to better manage non-performing loans, while promoting continued liquidity in the To Be Announced (TBA) mortgage securities market. The FHFA also states that the Joint Initiative is seeking to consider, more broadly, options for mortgage servicing compensation that lead to enhanced competition in mortgage servicing and origination, and that can be replicated across multiple future states of housing finance.

While ICBA is supportive of the FHFA's goals, we do not see either proposal truly addressing these goals. The recent past is littered with examples of where mortgage servicing needs improvement; we do not see either proposal as fixing the problems. Rather, the proposals offer incentives for servicers to allow credit quality to deteriorate on loans so the servicers qualify for higher fee income. ICBA is also greatly concerned that rather than putting forth a compensation program that enhances competition in mortgage servicing and origination, the FHFA's proposals offer no new benefits to small or midsized servicers. We are greatly concerned that instead, the proposed fee structure changes would accelerate the consolidation of the existing mortgage servicing rights market, increase the barriers to entry for institutions with the potential to service small and mid-sized servicing portfolios and ultimately increase the moral hazard of further concentration of the business in a handful of Too-Big-To-Fail institutions for the reasons stated below.

Service to Borrowers Would Not Be Improved

The two proposed compensation structures do nothing to incent improved service levels to borrowers in our view. Already, the GSEs, through separate initiatives, have implemented new standards for borrower contact, servicer responses, frequency of contact, processes to quickly provide alternatives to foreclosures, work outs, loan modifications and the like. These initiatives combined with financial penalties and rewards are designed to improve servicer responsiveness, resulting in few loans going to foreclosure. In our view, the FHFA should see how these changes are fully implemented and determine if they are addressing servicing problems before considering compensation changes.

Given that both proposed structures offer the servicer a separate revenue stream for non-performing loans (NPLs), we believe that they actually create a perverse incentive to let a loan go delinquent so the servicer can gain more income through the workout process. ICBA has heard strong objections from many community banks about this aspect of the proposals. While we realize servicing delinquent loans requires additional time and effort on the part of the servicer, we are very concerned that if fees are raised as loans deteriorate, there will be an incentive for servicers to let loans go delinquent in order to increase their fees. Community banks tell ICBA that they spend the needed time with borrowers to ensure that loans do not go delinquent and should be appropriately

compensated for keeping loans current. Yet, fees for current loans would be cut under the proposals.

The majority of loans are performing and most borrower interaction on performing loans relates to payoff quotes, questions on tax and insurance escrows, or payment questions. Community banks provide high quality personal service to their clients and as a result their delinquencies generally are below industry rates. This requires ample revenue to pay for staff and systems. Neither proposed structure provides this for community banks. In fact, both proposals would slash servicing fees for current loans by over 60 percent, making it impossible for community banks to support a mortgage servicing operation for GSE loans. As a result, these community banks would likely exit the mortgage servicing business (and others would see no incentive to enter the business), and sell all loans servicing-released to the large aggregators. Service to borrowers would deteriorate as most large aggregators are generally not in the same local area as the borrower.

Community banks that both originate and service mortgages see the importance in keeping the complete loan process—from application, underwriting, and closing to servicing—in the same institution. This gives the institution a vested interest in ensuring the mortgage was in the borrower’s best interest, was a good quality loan from the start, and the bank is quickly able to work with the borrower should problems arise. Too often originators became detached from the loan as volume was of highest importance and originators had no incentive to ensure the loan was repaid. Community banks are concerned that these proposals would continue this flaw in the system that has contributed to the breakdown of the mortgage market.

Financial Risk to Servicers Would Not Be Reduced

The FHFA offers changes to address a goal of reducing financial risk to servicers, the risk servicers incur when they book mortgage servicing rights (MSRs) on their balance sheet. Community banks would like MSRs to be less complex and less volatile, but we do not see that the proposals will offer improvement. Since MSRs are treated as an asset, their value must be constantly adjusted to account for changes in prepayment speeds, overall level of interest rates, capital requirements and the like. During times of low or falling interest rates, prepayment speeds increase and the value of the asset is written down. The opposite occurs when interest rates increase. Large servicers use various financial tools to hedge the risk of changes in the value of MSRs. However, hedging programs are costly and many small to mid-sized servicers do not have the expertise or cannot afford to administer a dynamic hedging program. Rather, they rely on a “passive” hedging program where their loan production levels and subsequent origination revenue offset the changes in value in their MSRs.

Regardless of which method a bank would use, there is still a cost, and determining the value of a MSR is not an exact science, especially in the current market. The FHFA along with the GSEs have promoted the change in the servicing compensation as a way to address the MSR valuation issue. In particular, the proposed flat fee for performing servicing would not cause MSRs to be created, thereby eliminating the need to hedge

them. This would address the issue of hedging MSRs as well as the proposed changes to bank capital requirements regarding the amount of MSRs that can be counted towards capital. At the same time, it also takes an option away from servicers (large and small) on how they choose to value this asset. It also creates a new standard in what the asset is worth which could impact MSR valuations on existing portfolios. We have strong concerns that the impact on MSR valuations will be negative, causing institutions to write down existing MSRs for no valid economic reason.

As such, the proposed changes to either a flat fee for service or a greatly reduced fee basically exchanges one (known) financial risk for two new additional risks: 1. The new “standard” servicing fee or compensation structure will have a negative impact on existing portfolios; and 2. The proposed flat fee will not be adequate to support the servicing operations of community banks where the cost to service is higher since community banks have to spread the fixed costs of servicing (people and technology) over a smaller universe of loans, as discussed further below.

Flexibility for Guarantors to Better Manage Nonperforming Loans Would Not Be Provided

In ICBA’s view, the goal should be to provide the guarantors *revenue* to better manage NPLs. Both proposed structures assume the GSEs will “retain” some portion of the excess yield to be used as a NPL fee. This “yield” would accumulate either in the form of a servicer specific reserve account or it would be just held by the GSEs to compensate servicers for working out delinquent loans. The amount proposed is 5bp which would equal to about \$75-\$100 per loan based on loan amount. Details on how these funds would be deployed to the servicer have not been made available. Presumably, the GSE would reimburse the servicer for their costs to cure or resolve a delinquent loan, a schedule of fees which would be tied to certain activities and/or outcomes, etc. Depending on whose costs are being used, the fee may not be adequate. Also, the frequency of payment will also impact the overall attractiveness of the structure. Does the servicer have to submit a monthly invoice to FHFA or the GSE? None of these details have been shared.

The new structure also only applies to new loans going forward, and as such does nothing to address the costs of managing the legacy NPL portfolios which are really the problem. Given the likely very low delinquency on new books of business, along with anticipated longer duration servicing books due to the historically low interest rates, it is likely any fund for NPLs created and accrued will build up quickly. This fund could grow to over \$250 million in the first year alone.

The creation of a reserve account tied to a specific servicer that would provide funds to offset costs for servicing NPLs has also been proposed. In some ways this is similar to structures used by the Federal Home Loan Banks’ MPF program. There are many questions regarding the ownership of the funds that must be addressed, such as: How are they tapped? How long do they remain in the account? Is there a maximum amount that can be built up? What would happen to the funds if the GSEs were liquidated? Since

none of those details have been provided it is impossible to fully comment. Also, since the reserve account is tied to the servicer, use of those funds is restricted, making it less attractive to the GSEs.

Continued Liquidity in the TBA MBS Market Would Not Be Promoted

We find it difficult to see how the proposed change in the servicing compensation structure in either of the options would benefit the TBA market for GSE MBS. In fact, the TBA market exists because of the standardization of the mortgage loans backing the MBS along with certain conventions around good delivery, strong liquidity, and the GSE (government) guaranty of timely payment of interest and ultimate collection of principal. The metrics of the servicing contract really have no impact on the TBA market. One could speculate that if MBS investors were concerned that too much of the servicing compensation was embedded in the coupon of the security that they may adjust their price for that security. But the fact that many MBSs are created and issued by originators who do not service the loans, and these MBS trade at similar (or identical) prices to MBS issued by originators who do service the loans, suggests that the structure of the servicing compensation has no real bearing on the pricing of the MBS.

Fee Levels Would Be Too Low to Remain in Mortgage Business

The proposal would significantly reduce or eliminate the minimum servicing fee of 25 basis points earned for performing mortgages. ICBA has been working with community banks to analyze the financial impact of the proposed fee structure. Our members have found that if the proposals went forward that the result would be a significant cut—estimates run beyond 60 percent—in fee income below what the banks are currently earning. Unless this income could be made up in another manner—particularly since their delinquent loan levels are quite low—they would be forced to leave the mortgage business. This would result in less choice for mortgage borrowers and further consolidation in the industry.

Summary

The Federal Housing Finance Agency is considering proposals to change both the method and the amount of compensation mortgage servicers receive for servicing mortgage loans sold to the Enterprises, implementing a specific fee paid for non-performing loans while cutting fees for performing loans. ICBA is greatly concerned about the impact on community banks of the FHFA's proposals that would result in a sharp reduction in mortgage servicing fee income for community banks, who predominantly service performing loans, forcing them out of the business and furthering industry consolidation. Any changes to the current mortgage servicing fee must recognize the differences between the community bank loan servicing model, its costs and limitations on resources, versus the large mortgage servicing businesses run by the large national aggregators. Further, changing the servicing fee structure could significantly deflate the value of existing mortgage servicing rights held by community banks which would impact their capital position and likely increase consolidation of the servicing business. Moreover, by rewarding the servicers of non-performing loans, the proposal would create a perverse incentive. Loan servicing fees should be structured to incentivize diligent servicing,

which can make the difference between keeping a loan current and a lapse into non-performance. Consequently, we strongly urge the FHFA not to go forward with the proposed servicing compensation changes.

ICBA appreciates the opportunity to comment on the FHFA's Alternative Mortgage Servicing Compensation proposals. We would be happy to discuss our comments further with you. Please contact either Ron Haynie at ron.haynie@icba.org or Ann Grochala at ann.grochala@icba.org or by phone at 202-659-8111.

Sincerely,

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