

# UMPQUA HOLDINGS

C O R P O R A T I O N

Parent company for Umpqua Bank and Umpqua Investments, Inc.

UMPQUA BANK PLAZA

One SW Columbia Street Suite 1200 Portland Oregon 97258

umpquaholdingscorp.com P 503 727 4100 F 971 544 3750



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Federal Housing Finance Agency

1700 G Street, NW

Fourth Floor

Washington, DC 20552

[Servicing\\_Comp\\_Public\\_Comments@fhfa.gov](mailto:Servicing_Comp_Public_Comments@fhfa.gov)

## Comments regarding Alternative Mortgage Servicing Compensation Discussion Paper

To Whom It May Concern:

On behalf of Compass Analytics and Umpqua Bank, thank you for the opportunity to comment on the *Alternative Mortgage Servicing Compensation Discussion Paper*. We look forward to interfacing with FHFA during the development of this proposal.

**Compass Analytics** provides valuation and interest rate risk management solutions to mortgage capital markets participants. **Compass Analytics** licenses its software **CompassPoint™** to mortgage originators, servicers and investors on a client or Compass-hosted basis.

**CompassPoint's™** loan-level models, integrated file mapping, aggregation tools, reporting tools, market and credit inputs, whole loan, structured cash flow and mortgage servicing rights analysis give **CompassPoint™** users the competitive advantage in originating, hedging and valuing all mortgage collateral. In addition to licensing **CompassPoint™**, **Compass** uses **CompassPoint™** internally to provide outsource hedge execution services which draw on Compass' considerable expertise and access to market color. For more information about Compass Analytics, please visit its website at <http://www.compass-analytics.com>.

Umpqua Bank, headquartered in Roseburg, Ore., is a subsidiary of Umpqua Holdings Corporation (NASDAQ: UMPQ), and has 192 locations in Oregon, Northern California, Washington and Nevada. The company reported just under \$12 billion in assets at the end of the third quarter of 2011. Umpqua Bank has been recognized for its innovative customer experience and banking strategy by national publications including *The Wall Street Journal*, *The New York Times*, *BusinessWeek*, *Fast Company* and CNBC. For the past five years in a row, the company has been included on *FORTUNE* magazine's list of the country's "100 Best Companies to Work For."

Compass Analytics, under contract with Umpqua Bank, views the proposals laid out by FHFA in the *Alternative Mortgage Servicing Compensation Discussion Paper* as detrimental to all of the originating and servicing market except very large “mega-servicers”. Leaving the current servicing compensation system in place, coupled with a convergence of guarantee fees between larger and mid-sized originators, will best address the reason FHFA has been tasked with addressing servicing compensation -- primarily poor customer service and loan servicing/mitigation practices that have been prevalent since the collapse of the housing market. Other reasons offered for these proposed servicing changes, (e.g. helping large servicers address Basel III balance sheet constraints), are best addressed in other ways, and as explained below, run counter to the spirit of these proposed servicing changes with respect to new production. Furthermore, large servicers are paring back their balance sheet exposure to mortgage servicing with significant reduction of correspondent originations (e.g. Bank of America’s exit, and partial exits by Wells Fargo, JP Morgan Chase, Citibank, MetLife and GMAC).

We acknowledge and understand why the great majority of loan servicing problems were concentrated in mega-servicers. Mega-servicers acquired the greatest volume of non-agency and agency loans due to their scale and competitive pricing advantage. Their pricing scale and advantage led to consolidation of mortgage servicing. The ensuing housing credit crisis that started in 2007 led to a tidal wave of delinquency, foreclosure, and loss mitigation activities, a volume very few in the industry or government predicted. Mega-servicers attempted to scale up operations to meet this demand but given additional regulatory requirements, and the sheer volume and the speed at which delinquencies and foreclosures came, the mega-servicers were simply not able to hire and train staff fast enough to provide scalable customer service and delinquency processing throughout this period.

Understanding the causes of this failure is important because it informs the detrimental effects of the proposed servicing compensation alternatives:

- 1) **Consolidation is NOT a good thing.** Concentrating servicing in so few hands led to a variety of dysfunctions. For example, the larger entities removed analysts, strategists, and risk and credit managers farther away from the relationship with the underlying borrower. This distance led to poor underwriting decisions and impersonal systems/intermediaries that compounded and helped create the credit, housing and servicing problems in the first place. Also, concentrated servicing made staffing-up to meet non-performing servicing demand a much harder task. It’s much more difficult for 5 mega-servicers in 10 locations to hire 10,000 servicing personnel than it is for 100 servicers in 150 locations to staff-up 10,000 servicing personnel.

The downside of concentration is evidenced by relatively superior performance of mid-sized banks both in their originations leading up to 2007 and their subsequent servicing practices. The proposed reserve account would do nothing to speed up the process of hiring and training additional staff during the next housing credit downturn. Instead, the added cost of funding the reserve account would be passed on in the form of higher rates, itself a tax on higher credit borrowers who are not as likely to default.

- 2) **Reduced service fees (e.g. 5-12.5 bps) will lead to MORE consolidation for a variety of reasons.** First, looking at the economics of servicing for the middle market servicers (see *Value of Current Market MSR Asset Based on Loan Size, Servicer Size & Servicing Fee* table below), reduced servicing fees provide very little economic incentive for small to mid-sized servicers to continue servicing. Originators can and do decide on every loan they sell, whether they will keep servicing or not. If reduced servicing fees lead to very little upside, yet carry all of the obligations, risk and focus of holding servicing, originators will decide NOT to keep servicing. This will further concentrate servicing among mega-servicers.

It's important to understand mega-servicers have more servicing revenue opportunities than small to mid-sized servicers (cross sell, float) with much less cost (due to scale). Reduced servicing fees mean servicing values will be worth very little to the small to mid-sized servicers. Mega-servicers can comfortably find profit margins in much lower minimum servicing fees or even \$120 per loan annually given the low costs and value they can extract from their relationship with the borrower. Contrast that with most mid-sized servicers and mortgage banks who use sub-servicers or service in-house at >\$120 per loan annually. Sub-servicers offer little float/ancillary or cross sell opportunity. Servicers will only retain risk if they are adequately compensated for that risk.

Second, larger servicers, even those with constrained balance sheet, will have a capital budget they can use to acquire servicing (again, there are other viable strategies for existing servicing like securitizations, which have been successfully completed in the past). If service fees are twenty percent to fifty percent of what they are now, those aggregators will acquire two times or five times as much as they otherwise would.

Finally, plans to separate the servicing interest only (IO) with a lower service fee will lead to an originator looking at selling an IO today for cash and being left with less service fee (see above). Small to mid-size servicers will exit servicing altogether, again concentrating servicing in larger servicers with scale.

**Value of Current Market MSR Asset Based on Loan Size, Servicer Size & Servicing Fee**

Loan Amount	Servicer Size & Fee	Servicing Fee		
		5 bps	12.5 bps	25 bps
100,000	Mid	-0.281	0.097	0.725
	Mega	0.286	0.663	1.292
	Δ	-0.567	-0.567	-0.567
200,000	Mid	0.000	0.377	1.006
	Mega	0.370	0.747	1.376
	Δ	-0.370	-0.370	-0.370
400,000	Mid	0.140	0.517	1.146
	Mega	0.412	0.789	1.418
	Δ	-0.272	-0.272	-0.272

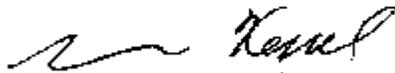
Values derived by Compass Analytics using representative prepayment, cost and revenue assumptions.

- 3) **Fee-for-service with future compensation schedules set by a government agency would dramatically arrest current trends of more originators keeping servicing and further promote consolidation.** The valuation of Mortgage Servicing Rights (MSRs) is already complex enough given the rate-dependency of prepayment speeds (and consequently values). Rate movements impact servicing portfolio values in an opposite manner than they impact origination profitability. Originators have for years employed a natural hedge between the portfolio and the origination channel. However, at no time in history has the servicing revenue from existing loans been tied to the future price setting by a government agency, ultimately controlled by political policy makers. Any fixed servicing fee income that is determined annually by the government (FHFA) is extraordinarily risky. The market will only assume this will become a policy tool for officials to coerce or exploit servicers to change practices or suffer income reductions.

Valuing servicing, which we must do in the origination process (keep it or sell it), depends on discounting future cash flows. Adding a whole new layer of uncertainty to future cash flows, in addition to interest rates, would discourage many more small to mid-sized banks from keeping servicing and thereby promote further consolidation among mega-servicers.

In summary, the proposed alternative changes to lending/servicing practices should not solely, or primarily, benefit the very participants who created the problem in the first place. Most originators, including small mortgage banks, credit unions and larger regional institutions, strongly believe these changes are not only unnecessary, but detrimental to their business model and practices. As a representative and advisor to these entities, Compass Analytics strongly recommends against the proposed changes and instead favors retention of current servicing compensation coupled with convergence in guarantee fees between mid-and mega-sized servicers. Umpqua Bank, a client of Compass Analytics, completely concurs in this position. Please contact us if we can provide additional information. Thank you for your consideration.

Sincerely,



Rob Kessel  
Managing Partner  
Compass Analytics, LLC  
580 California Street, Suite 1725  
San Francisco, CA 94104  
415-462-7500  
[rkessel@compass-analytics.com](mailto:rkessel@compass-analytics.com)



Steven L. Philpott  
EVP/General Counsel  
Umpqua Bank  
675 Oak Street, Suite 200  
Eugene, OR 97401  
541-434-2997  
[stevenphilpott@umpquabank.com](mailto:stevenphilpott@umpquabank.com)