From: Glen Corso [mailto:glen@mortgagepolicy.org]
Sent: Wednesday, December 21, 2011 2:54 PM
To: #Servicing Compensation
Subject: CMBP Comments on Discussion Paper

Dear Sir/Madam:

Enclosed is the Community Mortgage Banking Project's comments on the Alternative Mortgage Servicing Compensation Discussion Paper.

Glen Corso

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Community Mortgage Banking Project

December 22, 2011

Mr. Edward DeMarco
Acting Director
Federal Housing Finance Agency
1700 G Street, NW, 4th Floor
Washington, DC 20552

Submission to: Servicing_Comp_Public_Comments@FHFA.gov

Re: *Alternative Mortgage Servicing Compensation Discussion Paper*

Dear Acting Director DeMarco:

This letter represents the views of the Community Mortgage Banking Project, a public policy organization representing independent, community-based mortgage banking companies engaged in the origination, sale and servicing of residential mortgages. We appreciate the opportunity to comment on the Alternative Servicing Compensation Discussion Paper (Discussion Paper).

There has been much emphasis in the Discussion Paper and in our meetings with FHFA, Fannie Mae, Freddie Mac and Ginnie Mae regarding the importance of providing an incentive structure in servicer compensation that encourages more small lenders to *retain* the servicing on the loans they originate. We support the objective of what we call the "re-localization" of servicing, and note that the views and concerns we raise in this letter reflect those of traditional, independent mortgage banking companies that have been originating and retaining servicing for decades.

Summary

The current compensation structure for mortgage servicing has not been a cause of the current difficulties in the mortgage servicing industry, nor does the Discussion Paper provide any evidence to the contrary. Some refinements may be in order to enhance the value that mortgage servicing delivers to borrowers, investors and guarantors, but wholesale or radical change is not warranted.

Of the two options presented in the Discussion Paper, the reserve option, with some modifications we suggest, appears to best address a key issue inherent in the current compensation structure, that of financial resources from the servicing portfolio declining as delinquencies, and attendant expenses, increase. The second option involves a radical, and we believe totally unwarranted restructuring of mortgage servicing compensation, that will involve a massive shift of property rights from mortgage servicers to the GSEs. This is unwise public policy, particularly given the conservatorship status of both GSEs.

Nowhere in the Discussion Paper, we would note, is it made clear how either option would improve service to borrowers.

Overview and Background

We agree that mortgage servicing difficulties are real, and are creating hardship for many borrowers. These difficulties need to be addressed in a comprehensive fashion, and refinements in mortgage servicing compensation could be a part of the answer. However, any refinements to mortgage servicing compensation should be focused on producing the maximum benefits to borrowers, servicers and guarantors with the least disruption to the mortgage market. In particular these refinements need to be done in a manner that will create additional financial resources for mortgage servicers to provide better service to borrowers, specifically in the management of non-performing loans (NPLs).

The current servicing difficulties arose out of a serious breakdown in the loan origination process. High-risk products were extended to borrowers who lacked the requisite knowledge or appreciation of the risks inherent in the loans. More importantly, these borrowers lacked the financial resources to deal with those risks because underwriting standards were relaxed well beyond the limits of prudence. The pressure put on mortgage servicers by this dangerous combination of poor underwriting and high volumes of risky and untested loan products was exacerbated by the spike in unemployment caused by the 2007-09 recession, which in turn affected borrowers with more traditional loans products, creating the housing collapse that the entire mortgage industry, and most areas of the economy, are still dealing with today.

The efficacy of the response by the mortgage servicing industry to this breakdown varied greatly, primarily along the lines of portfolio size – specifically the volume of higher risk loan products serviced. The larger the portfolio of nonprime, nontraditional loans in the servicer's portfolio, the greater the level of difficulties that have been evident in their ability to manage NPLs. These problems usually have extended across to their servicing of prime loans.

Exacerbating this situation of poor performance on the part of some of these large mortgage servicers has been the fact that the servicing of GSE loans is highly concentrated. With 75% of GSE mortgage servicing rights (MSRs) owned by 5 mortgage servicers actions, mistakes, slow responses, short cuts or inaction at these servicers has a broad and far reaching impact on a large number of consumers with GSE loans.

This concentration has had a further operational impact on the GSEs. In terms of the panoply of options available to the GSEs to address poor performance by mortgage servicers, the ultimate option is the forced transfer of MSRs – either with or without cause. By facilitating the current concentration of MSRs in 5 companies, through volume discounts on guaranty fees and other preferential treatment, the GSEs now find that they have lost their ultimate leverage with their top servicers – in effect, these servicers have become too-big-to-discipline and too-big-to-terminate. The result has been a compromised ability on the part of the GSEs to effectively manage their largest servicers to take the actions the GSE's believe are necessary to improve the servicing of NPLs.

The key points in this discussion are the following:

- The root cause of the servicing problems currently being experienced by borrowers, investors and guarantors were fundamentally caused on the origination side of the mortgage business. The best way to "fix" these mortgage servicing problems is to take steps to prevent the origination of hundreds of billions of poorly underwritten, highly risky loan products. Many of the reforms in the Dodd Frank Act are designed to accomplish that goal.

- It is clear that some individual servicers faced significant operational problems caused by an unanticipated wave of mortgage delinquencies and defaults. However, the FHFA presents little evidence in the Discussion Paper that clearly links these operational problems to improper incentives in the current servicer compensation model. In fact, FHFA's paper acknowledges that under the current servicing compensation model "a servicer is incented to keep loans current, or to restore loans to a performing status, in order to maintain their servicing fee cash flows."

With this background, and absent evidence of fundamental flaws in the servicer compensation model, we recommend that reform efforts be focused on targeted enhancements to the current compensation model rather than radical changes that will have unknown consequences for lenders, servicers, investors and borrowers.

Servicing Compensation and Concentration

Our analysis, coupled with FHFA's own conclusion regarding the current mortgage servicing compensation system, would indicate that actions that address the concentration of MSRs issue should be a primary goal of any effort to address the alignment of interests between mortgage servicers and the GSEs.

As an initial step to begin the de-concentration effort, we would urge FHFA to immediately direct the GSEs to cease all discounts on guarantee fees, loan level pricing adjustments and other preferential treatment to large lenders based on the size of the lender, the volume of loans sold, or proxies for size or volume.

Further, we would urge continued work on targeted refinements to the servicing compensation fee structure that we believe would permit additional resources to be available to servicers to use in their management of NPLs. However we specifically recommend against any radical restructuring of the mortgage servicing fee that would permit the current concentration of MSRs in the hands of a few large lenders to continue or to grow further.

De-Concentration Underway

A combination of market and regulatory forces are already creating a trend towards reversal of the unhealthy concentration of GSE MSRs. Some of the 5 largest servicers of GSE MSRs have either eliminated or reduced their correspondent lending operations through which they buy newly originated mortgages on a servicing-released basis. For the rest of the large banks, compliance with the Basel III capital standards, particularly with the MSR limitation for Tier I capital, will require a significant slow down in their accumulation of GSE MSRs, if not outright disposition, in order to avoid the capital consequences of breaching the Basel III limit.

Even though the Basel III requirements are not effective until 2018, bank holding companies regulated by the Federal Reserve must submit their plan on how they will attain compliance with the Basel III capital requirements by mid-January 2012. While existing regulatory and market forces are already encouraging more lenders to retain servicing, and some of the larger lenders to reduce their MSR exposures, precipitous action by the FHFA could have unintended consequences. For example, eliminating the capitalization of the MSR asset altogether, as FHFA has proposed through the fee for service option, could halt the healthy re-localization and de-concentration process already underway.

Balanced action is needed that preserves and enhances the economic incentives that are encouraging smaller lenders to retain servicing. Guarantee fee parity, along with modest changes to the servicing compensation structure, will increase competition, "re-localize" the servicing business, and help reverse the excessive concentration, all to the benefit of consumers, the GSEs and the mortgage market place.

Suggested Refinements To Servicer Compensation

As we note later in our comments, the proposed fee for service model raises too many unanswered questions that could lead to unanticipated or unintended consequences for borrowers, investors, servicers, and the broader market. The Community Mortgage Banking Project recommends incremental refinements to servicer compensation that we believe will better serve the objectives the FHFA articulates in its own discussion paper:

- Improved service to borrowers
- Reduced financial risk to mortgage servicers
- Flexibility to guarantors to better manage NPLs
- Continued liquidity in the TBA mortgage securities market

We recommend that FHFA pursue the further development of the so-called "reserve model" concept, similar to the MBA and Clearing House Association proposals contained in the Discussion Paper, but with some important variations. In earlier meetings with the FHFA/GSE team managing the servicing compensation initiative, we had suggested adoption of the servicing compensation model used in the GNMA II program, which features a designated range for the minimum servicing fee. At the initiation of the securitization process the issuer/servicer chooses a servicing fee somewhere along the range and that becomes the minimum servicing fee for that group of loans until they are paid off or otherwise retired. CMBP's recommendation to FHFA is a pairing of the concepts – adopt a range for the minimum servicing fee coupled with a reserve account.

We suggest a minimum servicing fee range of 12.5 basis points to 25 basis points plus a reserve account of 3 basis points. We would further urge consideration of a wider range – from 12.5 basis points to 37.5 basis points – dependent upon the cost and complexity of the expected new servicing standards and requirements, whether they are achieved through litigation settlements, imposed by the Consumer Financial Protection Bureau, and/or required by other federal or state regulators. Designating a minimum servicing fee range recognizes that there are a variety of servicing models among lenders with different cost structures. In order to satisfy two of the stated goals – improved service to borrowers and reduced financial risk to servicers – the adoption of a range for the minimum servicing fee permits servicers the flexibility to build in the level of servicing compensation that will create the financial resources necessary to provide a high level of service to borrowers during periods of "normal" or "expected" delinquencies.

The reserve account concept satisfies one of the other major goals set out in the discussion paper – better management of NPLs by servicers on behalf of the GSEs. The reserve account provides additional resources for servicers to deploy in taking actions required by the GSEs on NPLs, particularly during periods where delinquency levels exceed "normal" or "anticipated" levels. The existence of the reserve account, and the ability of a servicer to draw upon the reserve account to pay for specific actions taken on NPLs, will address the one of the key concerns in the current mortgage servicing compensation structure: that financial resources generated by the servicing portfolio decline when NPLs, and costs, increase beyond expected levels.

The reserve accounts should be held by the mortgage servicers, in a segregated trust account, and tied to the MSRs. Therefore the reserve accounts would transfer if the MSRs were transferred, and would be protected in the event of servicer failure. Servicers should be required to add to the reserve account until it reaches an amount equal to 10 basis points of the combined principal balance of the GSE portfolio that carries a reserve account style servicing fee.

Further we would suggest that FHFA appoint a joint panel, consisting of mortgage servicers representing a cross-section of the industry and GSE representatives to develop triggers that will result in the specific actions, and the associated compensation, that will be funded from the reserve account. This same joint panel should develop the performance standards mortgage servicers will be held to in the management of NPLs, and the guidelines they follow in their management activities.

Adoption of a 3 basis point reserve account model, coupled with a designated minimum servicing fee range of 12.5 to 25 basis points, will address the FHFA's stated objectives in the servicing fee initiative, as follows:

- Preserves the existing incentive structure for servicers to keep borrowers current, and to restore delinquent borrowers to performing status in order to maintain their primary cash flows. This serves the interests of borrowers, investors and guarantors.
- Provides servicers the flexibility to reduce (but not eliminate) the capitalized MSR, reducing their financial risks and hedging costs, and assisting bank-owned servicers in mitigating the adverse impact of the Basel III capital rules.
- Allows servicers to set the minimum servicing fee at a level that reflects their differential costs, increasing the propensity of small lenders to originate and retain servicing, increasing competition and reducing concentration in the servicing sector. Borrowers will have more options to get loans that are locally originated and serviced.

- Requires servicers to continue to have "skin in the game," which increases incentives for quality originations and reduces incentives for churning.
- Provides for the creation and maintenance of financial reserves that can be used for enhanced servicing of nonperforming loans. This benefits guarantors, investors and borrowers, particularly during periods when delinquency levels exceed "normal" or "anticipated" levels.

By making more modest and predictable changes to the system, this proposal reduces the likelihood of unanticipated or unintended consequences. In particular, the range concept operates well in practice in the Ginnie Mae II program, and should provide a framework for the GSEs to build on. In addition, by designating a range of acceptable minimum servicing fees, this proposal is less likely to create unanticipated problems with the tax safe harbor for the MSR asset (a significant problem with the fee for service model, as noted below).

Fee for Service Concerns

We would like to conclude this letter by highlighting our serious concerns with the fee for service proposal. We believe that fee for service model would create a huge disincentive for mid-sized and smaller servicers to invest in their servicing operations. If fee for service were adopted by the GSEs, we believe the ultimate result will be poorer service for borrowers, greater financial risk for mortgage servicers, reduced ability of the guarantors to manage NPLs, and a reduction in liquidity in the TBA market. We also believe this proposal will make it significantly more difficult for Congress, and the FHFA as conservator, to develop and implement a conclusive wind-down of the GSEs.

Property Rights Shift – as proposed the fee for service concept would require a dramatic shift in the ownership of mortgage servicing rights away from mortgage servicers and to the GSEs as master servicers. The concept, as outlined in the Discussion Paper, would provide the GSEs with first call, after the owners of the security, on the cash flow from the loans being serviced, with the 8 basis points master servicing fee they would be paid. The GSEs would then pay their contractors – the mortgage servicers actually performing the work – a set dollar amount per month for the servicing of the loan assets from their 8 basis points master servicing fee.

The very term – Fee for Service – clearly implies a vendor status for mortgage servicers. Vendors are entities that get paid a fee to perform a service with no ownership rights in the underlying financial asset, i.e. the right to service the mortgage. Thus ownership of the MSRs would shift from mortgage servicers to the GSEs as master servicers. In simplest terms, the fee for service proposal would turn current primary servicers into *subservicers*, but leave them with almost all of the attendant risks and obligations associated with *owning* the servicing rights. We believe most small servicers – and perhaps some larger ones -- will find this trade untenable and will no longer retain servicing.

From a public policy perspective, this arrangement appears incongruous to us for two reasons. First the GSEs are currently in conservatorship with no foreseeable chance of regaining solvency. It is the express goal of the Administration and Congress that the GSEs be placed into receivership or into an otherwise orderly wind-down and phase-out. It would significantly complicate the goals of policy makers if the FHFA were to implement a servicing compensation program that would create a massive shift in property rights (and attendant ownership risks) from the private sector to institutions that are only being kept solvent by quarterly capital injections from the U.S. Treasury.

Second, the fee for service proposal would place the GSEs at the center of the servicing of the mortgages for the 30-year life of those assets. By making the GSEs the master servicers on all of their MBS, the proposal puts the GSEs squarely in the servicing business, securing ownership and access to several revenue streams from every mortgage transaction. For example, the GSEs would earn the difference between the 8 basis point master servicing fee, and the $10 they propose to pay the servicer as contractor. In addition, the proposal would allow the GSEs to collect a fee for the proposed bifurcation of origination reps and warrants. Finally, the GSEs and the FHFA have both acknowledged that the fee for service model would require the GSEs to boost their guarantee fees to offset some of the risks they would assume.

In short, the fee for service proposal, if implemented, would give the GSEs significant new power in the mortgage market place, taking ownership and revenue streams that currently are earned by the private sector. Whether the shift in revenues and risks between the GSEs and private servicers is fairly apportioned remains to be seen, but this is a rather stunning power shift for institutions that are insolvent, absent periodic injections of capital from the U.S. Treasury.

Alignment of Interests – Currently mortgage servicers have a financial stake in the quality and performance of their mortgage-servicing portfolio because the MSRs, which are financial assets on their own balance sheet, are at risk if they fail to diligently manage the portfolio. This at-risk position for the servicer's MSRs aligns the servicer's interests with the GSEs' interests as guarantors for the loans, since the GSEs have financial exposure to the investor for any shortfall in scheduled principal and interest from the mortgages. Under the fee for service model, this alignment largely disappears. Rather than a capitalized MSR on the mortgage servicer's balance sheet being at risk to ensure the servicer's good performance, the servicer is at risk of losing a monthly fee that is the equivalent of the price of two non-fat latte's, not a particularly strong financial inducement as opposed to the financial exposure borne by the guarantor to the investor for shortfalls in principal and interest collected on the loans.

Mid-sized and smaller servicers – More importantly the fee for service proposal, under either option, would create a difficult financial situation for mid-sized and smaller mortgage servicers. The Mortgage Bankers Association's (MBA) 2010 Annual Mortgage Bankers Performance Report states that loan service expenses for mid-sized and smaller mortgage servicers average in excess of 18 basis points annually (excluding MSR amortization). So if the master servicer's fee is 8 basis points, of which only a portion will be paid to the mortgage servicer, how will the mortgage servicer cover the balance of their expenses, let along generate a profit?

The answer, according to the Discussion Paper and subsequent presentations by FHFA and GSE staff, is through income generated from the interest-only (IO) strip that is created at the origination of the loan. The income would be realized either upfront, if the mortgage originator/servicer is permitted to sell the IO strip, or periodically if the strip is tied to the MSR. Both options are suggested in the Discussion Paper. The difficulty is that the reduction in the servicing fee, and the re-classification of what is now a portion of the “normal” servicing fee as an IO strip has significant adverse tax implications that create a mismatch between the cash flow from the assets and the taxes that would be due.

The reclassification of a portion of the MSR as an “orphan” IO strip causes this asset to lose the tax safe harbor currently in the Internal Revenue Code for MSR income. If a servicer retains the IO strip they would be required to pay the tax on the full value of the IO strip that they capitalize on their balance sheet upfront, in advance of the actual receipt of cash income from the IO strip. While large, diversified bank-owned servicers may be able to manage these tax issues within the broader organization, independent mortgage banks and other smaller, less-diversified community banks would be significantly disadvantaged by this tax mismatch.

Alternatively, if the mortgage servicer chooses to deal with the tax and cash flow issues by immediately selling the IO strip, this action would eliminate the servicer’s at-risk position in the loans. It also would convert this asset from a counter-cyclical asset to a pro-cyclical one vis-à-vis loan production. Currently, banks and mortgage bankers that retain servicing have a flow of mortgage servicing income to rely upon during those points in the housing cycle when loan production, and associated revenue and income, are down. This so-called “macro hedge” is an important source of stability for smaller lenders.

Under the proposed fee for service option, the proposed “flexibility” to either retain or sell the IO strip is largely a false choice. The adverse tax treatment of the IO strip will incent most originators to sell this asset into the market. This not only eliminates their “skin in the game,” it also eliminates the macro hedge and makes them totally dependent on origination-related income. When the cycle turns down, these companies will no longer have the benefit of the countercyclical servicing income stream. Since they are stuck on the production treadmill, some companies may be inclined to loosen underwriting standards in order to maintain production volumes and income at the top of the cycle. This creates the prospect of unhealthy pro-cyclical behaviors and reduced financial stability.

In addition, de-coupling the IO strip from the actual activity of servicing will create a situation where the financial incentive for a small or mid-size servicer to either build a mortgage servicing operation, or to expand their current portfolio of MSRs, will be severely diminished. Why should a small lender make or expand an investment in MSRs when they can capture much of the upside return from servicing by originating the loan and selling off the de-coupled IO strip? Why take the long-term financial and compliance risks of servicing mortgage loans, particularly when the full extent of mortgage servicer duties and responsibilities remain in flux, for a nominal, fixed monthly fee that is locked in for the life of the loans? Why not originate the loan and sell the loan and IO strip along with the servicing rights?

This disincentive for mid-sized and smaller servicers will add to, rather than counteract, the current concentration of GSE MSRs among a small handful of mega-servicers, thus making the guarantor’s ability to manage NPLs just as limited, if not more so, than it is today.

Conclusion

As we noted in our overview, the performance issues in the mortgage servicing business do not arise from the compensation structure. However, there aspects of the current mortgage servicing compensation practices that could benefit from some refinement and enhancement. Continued refinement of the reserve concept, together with establishing a designated range for the minimum servicing fee from 12.5 basis points to 25 basis points, satisfies the four goals set forth at the opening of the Discussion Paper, without creating market disruptions or beginning a massive shift of property rights from functioning, solvent private sector companies, to companies on life support from the U.S. Treasury.

The appendix to this letter contains our answers to the specific questions posed in the Discussion Paper.

Thank you for the opportunity to comment and please contact us at 571-357-1036 with any questions.

Sincerely

Glen S. Corso
Managing Director

Appendix

Questions and Answers

1. What are the impacts of these proposals on the competitive landscape in origination and servicing markets, service to borrowers and efficiency in secondary markets?

   Answer: The reserve option would preserve the current competitiveness in the origination markets and enhance competitiveness in the servicing market. The reserve option would preserve and possibly enhance the de-concentration trends already underway in the market. By contrast, the fee for service option would depress the value of servicing, create great uncertainty in the value of loans sold servicing released due to the uncertain nature, duration and attributes of the "orphan" IO strip that would be created. By reducing compensation on performing loans, it would also devalue the servicing function, reducing investment in servicing and degrading the quality of services, with negative repercussions for service to borrowers.

   As for efficiency in the secondary markets, the reserve option would preserve the current efficiency. The fee for service option would degrade that efficiency due to well-placed investor concerns over faster pre-payment speeds due to churning of the portfolio by the origination arms of mortgage servicers that no longer have an MSR on the balance sheet associated with the servicing.

2. What are the benefits and/or the impediments to your business model of having a capitalized MSR asset?

   Answer: The benefits and impediments pretty well balance out. The asset is a positive addition to net worth but it can be volatile from quarter to quarter.

   a. Does a capitalized MSR impede competition to your business model in the servicing and origination market?

      Answer: The issue facing independent mortgage bankers in the decision to retain servicing rights is a cash flow issue – to what extent can they forgo the cash flow generated from the sale of loans servicing released, in order to retain servicing rights.

   b. Does the impact vary across various business and interest rate cycles?

      Answer: Not on the capitalization issue, it does on the cash flow issue. The servicing asset is countercyclical asset for independent mortgage bankers – servicing cash flows offset declining production income in a down market. It serves as a stabilizing force for independent mortgage bankers.

c. Does the impact vary across size of servicers and originators?

Answer: The impact varies across business models and to some extent size. Insured financial institutions that can access insured deposits for liquidity are better positioned to deal with the cash flow issues presented by the decision to retain a larger percentage of the servicing rights on loan origination volume.

d. Would greater transparency in MSR valuation improve the competitive landscape?

Answer: Perhaps, but MSR valuation rests primarily on estimates of the pre-payment speeds of the underlying mortgages and each company's assumptions that underlie the determination of those estimates will vary. If companies are improperly valuing the asset using faulty assumptions, the answer is not to propose radical changes to servicing compensation designed to make the asset "disappear."

e. What is the impact of a potential reduction in the tax Safe Harbor?

Answer: A reduction in the tax Safe Harbor increases uncertainty and raises the likelihood that mortgage servicers whose costs exceed the reduced Safe Harbor limits could face a greater likelihood of an IRS audit. That would not be an inducement to greater retention of MSRs by mid-sized and smaller servicers who might face that exposure. For smaller servicers that do not have large, diversified operations, the tax safe harbor is a critically important factor in any decision to retain or sell servicing.

f. Should the servicer be required to hold a capitalized MSR asset (effectively be an IO investor) as a condition of performing servicing activities?

Answer: Frankly the form of this question, particularly the parenthetical reference to servicers being IO investors, sums up the disregard for the loan servicing function that has marked this entire exercise. Yes, there are certainly financial and financial management aspects to mortgage servicing, and to the MSRs that lenders acquire. But "structuring away" this asset does not make these issues go away, it only creates new issues that will need to be addressed (e.g., new ways to ensure skin in the game, new ways to prevent churning, etc.).

At its heart loan servicing is about providing service to borrowers, investors and guarantors. Obviously each party is owed different services and duties of care by the mortgage servicer, and each party expects, and deserves, a high level of service from the mortgage servicer. The FHFA's own Discussion Paper acknowledges that the existence of the MSR on a mortgage servicer's balance sheet aligns the servicer's interests with the guarantor, which should be a good thing from the guarantor's perspective.

3. Should a lender's excess IO remain contractually attached to the MSR, or would seller/servicers prefer to have the excess IO be a separate stand-alone asset (unencumbered by the Enterprises)?

   Answer: Contractual attachment to the MSR better aligns the servicer's interests with the GSEs. While a stand alone IO that can be sold or retained appears very attractive, this optionality is not free – it has costs and creates uncertainty. We anticipate there would be a cost to that feature in the form of higher net worth and/or collateral requirements for servicers. In addition, the market for the new orphan IO is simply unknown. Finally, as noted in the comment letter, the tax disadvantage to retaining the IO makes that an unlikely option for an independent mortgage banking company, rendering this optionality a false choice for most small servicers.

   a. Does the impact from market-based pricing of the excess IO vary across size of servicers and originators?

      Answer: Since an IO derived from a strip of income from a GSE-guaranteed security is not now traded independently in the market place; it is impossible to answer this question. But clearly, smaller servicers could have difficulty developing liquid markets for their IOs.

   b. Does contractually separating the excess IO from the MSR create more liquidity and price transparency?

      Answer: Impossible to say, but we assume investors will be quite hesitant to purchase these IO strips since their performance will be hard to forecast. That will lead to poor pricing, or perhaps the GSEs being the only purchasers. This would mean limited competition and poor pricing, and raises major policy issues with respect to the desires of Congress and the Administration to shrink the GSEs' balance sheets.

   c. Is the flexibility to separate the operational activities (servicing) from the financial management activities (investing in and managing MSR/IO exposure) as outlined in the Fee for Service proposal, beneficial or harmful to the industry?

      Answer: For mid-sized and smaller mortgage banking companies the impact from the investment in, and management of, the MSR asset is grossly overstated in the Discussion Paper and in the verbal comments made during this process from certain GSE executives. For the independent mortgage banker it is not that much of an issue and rarely, if ever, rises to the level of influencing the decision on what level of MSR retention a company should have in a given period. This has been the consistent feedback that mid-sized and smaller servicers have provided on this issue.

4. Would these proposals encourage greater investment in non-performing loan operations or abilities in a benign market cycle?

Answer: Very difficult to answer this question without more detail about the services expected on non-performing loans and the fees to be paid. Based on the limited information available it would appear that the reserve option holds the promise of incenting greater investment in such operations, but the details would be a critical factor.

We think a loan level fee for service model – particularly if the revenues are based solely on the same fees (and penalties) as in the FHFA's Servicing Alignment Initiative – would be insufficient to build capacity, especially in a BENIGN environment, because there would be too few transactions (delinquent loans) to support the investment sought (loss mitigation capacity).

If the desire is to incent investment in nonperforming loan servicing capacity in a benign (e.g., non-stressed) market, we believe a reserve account -- which requires a "rainy day" set aside of capital -- is far superior way to ensure this investment. Servicing is a single business that involves collecting on both performing and nonperforming loans. While there is a need for specialty entities to support this business – subservicers and specialty NPL servicers – you can't build the compensation structure around these entities.

By analogy, cars are intended to provide quick, mobile and relatively fuel efficient transportation. But sometimes they crash, so you build in features like seatbelts and airbags to mitigate the impact. However, if the primary purpose were to protect against the injuries that could be caused by a crash, we would all be driving tanks. Clearly, that does not make sense. The reserve account approach provides the seatbelts and airbags that will protect against a (market) crash.

a. How does this impact the alignment between guarantor and servicer interests?

   Answer: Not sure what the word "this" in the question refers to. As we have stated previously we believe the reserve option retains the current alignment of interests between guarantors and servicers. By contrast, the fee for service option largely eliminates this alignment, and requires the FHFA to develop regulatory mechanisms as a substitute for this natural alignment (e.g., the proposed restrictions on churning, net tangible benefit test, etc.). In short, we trust the natural alignment over attempts to control it through prescriptive rules that may or may not be effectively enforced.

b. Would this improve service to borrowers?

   Answer: Again, not sure what the word "this" in the question refers to. Certainly greater investment in non-performing loan operation or abilities should improve service to borrowers, but that will be driven to a large extent on the details of GSE requirements and the compensation for meeting those requirements. Again, the reserve account model provides the capital to make those investments, and to flexibly respond to specific market conditions as they arise.

5. What would be the impact of the proposals on the TBA Market if there were no MSR capitalization?

   Answer: The essence of the TBA market is the principle that securities that are traded on a TBA basis are considered largely inter-changeable with each other, so that the details of the specific loans backing the securities need not be known at the time a trade is agreed upon. Given the fact that the reserve option, particularly with the refinements we have suggested, represent modest changes, indeed perhaps enhancements, to the current mortgage servicer compensation model, we do not believe there will be very much impact on the TBA market. The opposite would be true for the fee for service model, which we believe will be viewed by investors as an open invitation for churning of the loan pool by the origination arm of mortgage servicers. Hence securities issued under this structure would not be considered interchangeable with securities issued under the existing compensation structure, which would bifurcate the TBA market and reduce its liquidity.

   a. To what degree might be net tangible benefits test and other suggested provisions help mitigate any potential negative impact on the TBA market?

      Answer: The fundamental overriding factor the TBA market will focus on is that mortgage servicer's compensation for servicing loans and their investment in that income stream, will be largely unchanged in the reserve option and greatly reduced, and in the case of the investment, eliminated, under the fee for service model. The net tangible benefits test will not balance out that concern. As noted in response to the previous question, we think the natural economic alignment in current model, supplemented by the reserve account, provides better protection for investors than more rules from FHFA about churning that may or may not be fairly and effectively enforced.

   b. What additional steps can we take to assure continued liquidity in the TBA market?

      Answer: Adopt the reserve account model with the enhancements we suggest.

6. Should any of the following provisions that were proposed in the fee for service proposal be considered independent of any other changes to servicing compensation structure?

   a. Bifurcation of selling and servicing representations and warranties?

      Answer: We believe this would be beneficial to the market by making the responsibilities of each party independently accountable to the GSEs. It should be an option under the reserve account model.

   b. A net tangible benefit test for streamlined refinances?

      Answer: This will be largely duplicative of requirements that will be implemented under the ability to pay regulations due to be finalized by the Consumer Financial

Protection Agency next year. Moreover, the reserve account model preserves the skin in the game and creates economic incentives against churning.

c. Restriction of the amount of excess IO in a given pool?

Answer: Difficult to see how this would be of interest or benefit to the market.

d. Limitation of P&I advance requirements?

Answer: A reasonable limitation on such advances could be a major inducement to independent mortgage banking companies to retain larger amounts of MSRs since the financing of such advances is a major cost factor and plays a role in the determination of the amount of MSRs are retained.

e. Flexibility for excess IO execution?

Answer: This issue would benefit from a detailed discussion among securities traders, investors and lenders to determine if there would be such a market for orphan IO strips and what that market might look like. However, even if such a market developed, it would not overcome the tax treatment problems and other concerns with the fee for service model.