THE PRESTWICK MORTGAGE GROUP

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

Dear Acting Director DeMarco:

We appreciate the opportunity to comment on FHFA's *Alternative Mortgage Servicing Compensation Discussion Paper* dated September 27, 2011 (the "Discussion Paper").

Below please find our general comments on the Discussion Paper and our answers to specific questions for public comment contained in the Discussion Paper. In summary, it is our strongly-held view that the compensation structure for mortgage servicing should not be changed at all, or that, if servicing compensation paradigms must be changed, such change should come in the form of the reserve model proposal by the Mortgage Bankers Association as outlined starting on page 19 in the Discussion Paper.

Our firm, The Prestwick Mortgage Group, is a small advisory business located in Alexandria, VA and was organized in 1995 as a consultant to the mortgage industry, specializing, among other related disciplines, in the brokering of mortgage servicing sales and in evaluations of those assets.

It is presumed that those reading this response are familiar with general mortgage secondary marketing execution terms and mechanisms, with the terms of customary mortgage servicing compensation as they currently exist, and with the proposals to alter such compensation presented in the Discussion Paper.

It is also quite important to recognize that descriptions of servicing buying in this response could take either of two forms. One would be buying "naked" servicing assets unattached to the associated loan asset (which has already been sold) in a transparent

servicing sale transaction between servicers. The other would be buying a whole loan servicing released in either a wholesale or correspondent loan origination via the buyer paying a servicing released premium to the originator, rendering much more opaque the servicing value truly paid and truly accounted for. The latter form became the much more prevalent form of servicing buying, which contributed to industry consolidation, because only through this origination form of servicing buying could accounting, capital markets, and guaranty fee advantage considerations of origination and secondary marketing control be exploited to the unhealthy place that the servicing industry is traveling through and healing from now. It is this more prevalent form to which we are referring as "servicing buying," herein, generally.

General Comments:

The existing fee structure to compensate for mortgage servicing functions is a viable compensation paradigm now and for the future. The current structure, with a minimum service fee earned by the servicer of 25 basis points of the unpaid principal balance on loans sold to or securitized through Fannie Mae or Freddie Mac (the "GSEs", a term which we will use to describe the current mortgage guarantor organizations or any other current or succeeding organizations, whether government-sponsored or not, whose primary function in this regard is to guarantee loans to securities investors), served borrowers well for decades; it served banks, the GSEs, mortgage companies, and the investment community well for those same decades. Simply by the fact that we as an industry are having this discussion foisted upon us, some would apparently complete the preceding sentence with, "until it didn't." We would categorically disagree.

Servicing has had its operational issues in the last three years or so, born of individual servicers' actions, to be sure. Servicing has presented disproportionate financial risks, born of individual servicers' actions, to be sure. Control of servicers' practices, specifically non-performing loan servicing practices in this time, have always been the purview of the GSEs. If the servicer violates the guidelines, the GSE has the hammers of financial remedy in the form of requiring the repurchase of loans per its contract or of the removal of its servicer's approval to service (i.e., its servicing existence and the seizure of assets that would entail) at its disposal. The GSEs have a difficult time exercising this existential remedy in the case of large servicers, whose portfolios have proven uncontrollably large for the GSEs to transfer to servicers that the GSE feels, rightly or wrongly, are better-suited to manage a portfolio. The concentration of the overall market's servicing book in the hands of such monstrous firms happens to coincide with the locations of the most intractable borrower service problems, where the GSEs are hamstrung in their ability to remedy the problems via the tools at their disposal.

Of course, using what are ostensibly taxpayer funds in order to buy MSRs (mortgage servicing rights) and give them to an allegedly better servicer has already happened, so we guess we know what flexibility for the GSEs means now.

Servicing compensation, however, is not the cause of these operational, financial, and control issues. In fact, we would submit that current compensation structures, akin to "skin in the game," is the reason servicers did not throw in the towel unless forced to exit by the GSEs – which in many cases since 2008 was not a servicer operational quality issue but a power-based replacement-of-quality-and-competence-with-quantity-of-capital issue.

The economics behind requiring mortgage servicers to retain a 25 basis point service fee remain sound, despite operational issues born of, in our opinion, other reasons, namely:

- servicer size in the pursuit of performing-loan-servicing economy of scale
- such size that is born of risk-taking incented by capital markets and accounting artifice and created by the acceptance, by those who have turned out to be the biggest firms, of the very financial risk which the FHFA wishes to try to reduce, on the part of those larger servicers unwilling or unable to deal with the operational ramifications of their risk-taking
- those larger servicers were able to exploit the GSEs' misplaced faith in lower counter-party risk with a financially stronger large company to negotiate vastly preferred guaranty fee pricing, which allowed the cycle of size to keep repeating
- all of the above while, on a parallel track, the evolution of acceptable underwriting practices created a population of loans almost guaranteed to default in numbers unseen in the decades since the Great Depression, the majority of which were being serviced within servicing platforms too big to manage such defaulting loan populations.

It's not the servicing compensation causing the problems FHFA is charged with solving. While acknowledging the role of what is easy, in hindsight, to identify as poor underwriting, it's individual firms' exploitation of the accounting treatment of the MSR asset since the adoption of FAS 122, making accounting and capital markets considerations supersede the business considerations of servicing, without allowing those companies to fail for their lack of accounting modesty, that is causing these problems. Who created that list of incentives? Certainly not the compensation for doing the business of servicing, but instead the small number of large servicing firms themselves who have failed to live up to their servicing contracts after bowing to accounting and capital markets pressures and ignoring the operational responsibilities that led to the crisis. Changing the compensation structure will make the business considerations, whose outcomes we all want to see improve, that much LESS important than the accounting and capital markets considerations that these firms already have.

Via this discussion, FHFA is trying to solve observable problems in ways that the market itself is already working its way through under the current compensation paradigm. Among these problems, financial risks are already being mitigated by lower prevailing servicing valuation in the current marketplace. Many of the largest servicers are either preparing for the implementation of Basel III (which will have the effect of forcing many of the biggest banks to hold vastly more capital against their MSR book value) or simply paying lower prices than have historically been paid for servicing via servicing-released correspondent channels and which the market will allow them to bear:

- to reflect truer MSR value recognition on the part of buyers of whole loan, servicing released assets,
- to make up for MSR book value losses resulting from prior overpaying-and-overbooking-in-retrospect in paying lower pricing now on better underlying assets, because the competitive market allows for it now

Further, some are simply making way for other providers to serve the market (such as Bank of America's recent exit from correspondent lending). Further still, taken together, the biggest servicing firms are losing market share of servicing, according to the mortgage trade press. Such developments are movements in a healthier, more competitive direction. The business economics of the servicing business in the current environment are finally making the accounting and the capital markets pressures bow, rather than the other way around.

The current paradigm of a 25 basis point minimum service fee on conventional loans IS WORKING. No radical change is needed on any rational economic basis. The current structure aligns servicer's interests with the GSEs and investors because the servicer does not get paid to service non-performing loans. The incentive on the part of the servicer is to get the defaulted borrower re-performing in order for the servicer to earn his servicing fee. The failure of these incentives to produce better outcomes is something that changing servicing compensation simply will not solve.

The FHFA's stated goals are laudable on their face:

- Improve service for borrowers
- Reduce financial risk
- Provide flexibility for the GSEs to manage non-performing loans while promoting TBA liquidity

Radically changing the compensation structure for mortgage servicing to either variation (or "option") of Fee for Service ("FFS") from the Discussion Paper may be a solution to one of these problems for the largest servicers, but certainly not all three at once for the

business in general. As a solution, the FFS model hardly incents better borrower service in the service of investor and, by extension, GSE interest.

To the extent that events remain in a servicer's control, you really will get what you pay for and won't get what you don't pay as much for. To believe otherwise is to ignore human nature and the profit motive of business. Under the current paradigm, you get as many performing loans to stay performing as are able, because that is how the servicer receives compensation. Under the Reserve Proposal as prepared by the MBA and described in the Discussion Paper, you get as many performing loans to stay performing as are able, because that is how the servicer receives higher-and-best compensation. The incentive of FFS, operationally, is to give up on the borrower when a borrower faces imminent default rather than working hard to keep the borrower current – unless the servicing of the default loan does not dictate getting paid an adequate amount, in which case borrower service will suffer; or unless the servicer of the default loan simply decides that he cannot service for this year's compensation level, which puts the servicer of the defaulted loan into the driver's seat to demand more compensation or the GSE into the position of duress to have to move the loans to another servicer, assuming a suitable one is willing at the "set" defaulted loan compensation for the year. "You will get what you pay for." What happens when a default cycle similar to 2008-2011 happens under FFS, and none of these firms can keep up with the default deluge, and none of the other firms has the capacity to take on the loans competently? Sounds familiar. Some kind of flexibility for the GSEs, no? FFS turns the compensation incentives on their head and puts the default servicer into the position of power, and while default servicing is important, that incentive cannot be good for an investor or for the GSE or for the borrower population.

We all agree that keeping a borrower current is not a futile effort in all cases, don't we? And we do all agree that keeping a borrower current is in the interest of all the parties involved in the mortgage business, except for the firm that profits from loan default, don't we? And we do agree that keeping as many borrowers as possible current is in the interest of the investment community, the GSEs, the government, and society at large, don't we? Hence, by the creation of a new class of interest-only strip ("IO" or "IO strip") asset divorced from the operational considerations currently tied to the mortgage servicing ("MSR") asset, the FFS removes incentives for the notional FFS servicer to behave in a way that benefits borrowers, investors, or the GSEs. Indifference on the part of the servicing operation will warp the outcomes toward that which profits the servicer the most, and there truly are servicers for whom it costs less to service non-performing loans than others. That lower cost, however, does not confer competence on that servicer. It simply confers tautological lower cost. Yet under FFS, we would still presumably be paying servicers for competence, as an industry, right? While FFS may solve the reducing financial risk part of the triangle, how does this serve the interest of

the borrower service? Or the interest of the GSEs? Or the interest of the investment community? It simply does not.

Further, FFS will dramatically reduce the number of servicers who will be willing to accept the responsibilities of servicing for a more paltry servicing cash flow that the marketplace would force servicers to accept, ultimately. Radically changing the compensation structure will lead to unintended consequences that will incent servicers into operational practices that will one day, long from now, make regulators and the GSEs (or their successors, notional or otherwise) long for the halcyon servicing days of 2008-2011. We all can agree on how halcyon these days are not.

While we do not endorse a change to the current servicing compensation model at all, we do recognize that there is a feeling among the regulators that there is a need for change. If FHFA feels strongly that making any change to the servicing fee structure is necessary, of the options presented in the Discussion Paper, we strongly urge FHFA to adopt the cash reserve model as proposed by the Mortgage Bankers Association ("MBA") (the "Reserve Model") in a 20/5 construct. Of the two proposals presented (each presented in a pair of variations) in the Discussion Paper, the Reserve Model is the only one which truly could be argued to meet FHFA's stated objectives while ensuring minimal disruptions to the market and retaining an ability for competent mortgage servicing providers to compete – and minimal disruption will indeed help borrowers and the housing market.

One of the main reasons that the "Reserve Model" in the MBA's proposed architecture of 20/5 (20 basis points being paid for performing loan servicing with 5 basis points being placed in trust/reserve in order to compensate for future non-performing loan servicing or to inure to the benefit of the servicer for loan performance) as described in the Discussion Paper is so vastly superior to all other proposals is that the economics of the business would remain sound while making incremental changes that would result in satisfactory movement toward the combination of outcomes that FHFA deems desirable, namely those listed above. Borrower service at just the time that default is imminent and even after the loan has gone into default would be compensated for explicitly. Financial risk would be reduced in some way because the performing loan cash flow would be reduced and the non-performing cash flow would be unlocked to compensate for cost-intensive functions done properly. Flexibility for the GSEs to manage non-performing loans would be maintained by the fact that the mortgage servicer would have an asset to defend/lose for his operational shortcomings. TBA liquidity would be maintained, because the market paradigm would be tweaked in ways both recognizable to the TBA and mortgage-backed securities markets and could be argued to be intelligent for the servicing business.

The fact, however, that the markets are healing themselves, without any servicing compensation change, leads us to advocate strongly for either no change or the MBA's "Reserve Model," which would continue to fund business functions and incent mortgage servicer conduct in proper directions with minimal market disruption.

Improving Borrower Service

The mortgage servicing industry's ills, represented in the cultural and political realm by the phenomenon of "robo-signing," have not been caused by compensation structures, but instead, by individual firms' inability to manage functions, which they plainly knew were their responsibility, in an efficient or, allegedly and possibly, legal way. The servicers who were the problem did not foresee the default problems the country has experienced, and did not prepare for their contractual obligations properly. A sympathetic observer may give these servicers a pass because of sheer volume of problem loans that went bad in a very short amount of time. However, these firms did not have a problem cashing checks and earning their fee. Why these individual firms were unable to manage default servicing has nothing to do with the incentives of compensation, but instead:

- with the incentives of cost-cutting to increase performing-loan-servicing economy of scale and, by extension, balance sheet value, when markets establishing value were tamed by the few large servicers to their own growth ends;
- with the incentives of the ethic of paying maximum profits to shareholders and owners for short-term appearances, rather than banking some of those profits for a rainy day in the longer-term;
- with the incentives of growing balance sheets at any accounting cost at, among other reasons, the behest of the GSEs to minimize theoretically their counter-party risk, which we have seen turned out not to be minimized, in order to negotiate more advantageous guaranty fees;
- with the need to rush performance of functions on behalf of investors in volumes unseen before in platforms of unprecedented size with small default loan servicing departments that were unnecessary-to-expand until a sudden flood of defaults rushed at them; and
- with the need to comply with individual state regulations that are often different between states and possibly at odds with investor requirements and expectations.

When confronted with the tidal wave of defaults that came at the start of the recession in 2007-8 and which have not abated in any meaningful way, mortgage servicers, especially large ones, were unable to keep up, even though they were getting paid explicitly to service performing loans and to keep them performing. Their reasons for poor service in the face of this tremendous volume of defaults were varied. Willful incompetence may be the appearance to an observer, and in some cases that may be fair. Regardless,

servicers are paid for competence in performing all contractual servicing functions for performing and for non-performing loans. Willful cutting-of-corners in the name of expense efficiency is a less-than-kind way to describe the pursuit of any efficiency/economy-of-scale where little or none may exist, such as is the case with default servicing, where legal friction and borrower protections make the default servicing sector of the business highly labor-intensive. The efficiency could only be had in the competence that was overwhelmed by sheer volume of delinquent borrowers within a couple of months.

What happens when the expense for performance of a function does not lend itself to any appreciable efficiency in an organization built on finding efficiency? What happens when that function is rarely performed and then such functions must happen constantly? These rhetorical questions describe the entire litany of non-performing loan functions that went from small specialty within the largest servicing platforms to the ubiquitous function that operationally buried many of the largest servicers who neglected the specialty required by their servicing contracts, because for 15-20 years, defaults were generally predictable in small numbers.

Through the most recent 3-year period, smaller servicers did feel pain. They were not, however, buried en masse by the performance of the functions to which they obligated themselves when agreeing to service loans. Why? Because they had an existential worry for their business if they did not function properly and because they had a cash-flowing asset worth protecting, which they did not want to have taken from them by the GSE. They got it done correctly, for the most part, and paid dearly if they did not. They had the competence card that generally did not get overrun by defaults, even in this unprecedented environment. They did it without putting undue financial risk on the system, but instead on themselves. They did it without leaving borrower service at the side of the road. They did it without getting so large that they were unmanageable by the GSEs. Certainly, some did not service properly. Most, not all, that exited the GSE servicing business, were forced to do so because of net worth requirements being increased to the point that they were unable to comply. Yet they were the ones often performing the operation of the business correctly, at minor risk to the GSEs.

Just as it is pretty ironic that borrowers complain the most about poor borrower service from their mortgage servicer at right about the time the borrower breaches his mortgage contract; so too is it ironic that servicers complaining about not getting paid for non-performing loan servicing that they contractually agreed to perform is a reason that servicers claim to the GSEs that they can't do what they have to do.

A complaint about not getting paid to service defaulted loans would be a pretty good one to address if it weren't so obvious that the incentive structure of the current service fee

paradigm should lend itself to loan underwriting quality to predict better performing loans and a servicer's natural desire to protect that cash flow by keeping the loan performing. Sub-prime servicers at the beginning of the decade were paid 50 basis points to service performing loans of more questionable underwriting and still had horrible non-performing loan track records. There's a reason that most of them are not with us. But it's not because they weren't compensated. It's because, generally, they either spent the money they should have been holding aside for that rainy day or the wave of defaults on poorly-underwritten loans simply overtook their ability (or willingness) to keep up. When the rainy day necessitated performance? There was not the capacity to service borrowers well. No matter how well servicing is done, it cannot make up for origination or underwriting problems on loans made to borrowers who did not have the financial resources or good fortune in the employment market to continue to make payments to the servicer.

The Reserve Model at the MBA's proposed 20/5 construction would theoretically improve the service to the borrower in default, by forcing the servicer to do the right thing in order to unlock the cash in reserve to fund his operations, and yet still incent good underwriting by the originator who also services, but only if the marketplace did not misprice and overpay, ultimately, for the MSR asset.

Reducing Financial Risk

We are seeing just such a recalibrating phenomenon of reducing market pricing for servicing via total execution correspondent execution play out in the marketplace, providing mortgage bankers a choice to sell or hold servicing – rather than the default position of having to sell servicing in a variety of ways for the 10 years or so leading up to 2008 because the market was paying too much for it. The smart choice became so obvious that it was no longer a "choice" but a virtual requirement of the marketplace to sell. And despite entreaties to the contrary, with the GSEs saying the difference in guaranty fee for the big guys is "not what you think it is," it is surely the case that individual firms at the very top (not necessarily the top 10, but the top 2 or 3) got guaranty fee pricing perks that were well in excess of the 4 basis points that FHFA's metric of the top 10 average vs. the next 100 average guaranty fees would imply. The top 2 or 3 are good, to be sure, in working the numbers, but they could hardly be as good as their pricing for years leading up to the 2008 crisis would imply without such a pricing advantage.

Of course, the incentives for good underwriting were co-opted by pursuit of MSR book value by the top handful of what have become the generally-regarded "too big to fail" banks. Originators were conditioned for 15-20 years to commoditize the loan,

- selling it servicing-released, often to one of the largest servicers (or what are now their predecessors),
- washing hands of the loan originated to the underwriting guide by selling to a buyer
  - who secondary markets the loan to the GSE and makes the representations and warranties directly to the GSE
  - who looks back at the seller/originator for representations and warranties that should mirror the same that the buyer made to the GSE
  - who accepts the risk of servicing the loan and who compensates the originator for the servicing right to put on his books at an inflated value relative to what it could be sold for,
  - because that buyer needed that higher value in order to remain solvent and to be competitive in the origination marketplace with others who were pricing with the same warped <u>accounting</u> incentives.

What happens when the intrinsic value of an asset isn't what you priced it for on your balance sheet? What happens when the market is wrong but gives a firm cover to work with a number much higher than any intrinsic value ultimately could be expected to be recovered? Conversely, what happens when the market is wrong and not working in your favor? What happens when that balance sheet value is what allows you to gain market pricing power by justifying higher value than that intrinsic value? What happens when you pile guaranty fee advantages on top of that willingness to value highly relative to other players? Welcome to the issues that the market itself is indeed working through and correcting.

The originator who complies with the guide has made an economic decision to sell servicing released, because the rational thing to do is to sell to a buyer pricing the servicing at what appears to be an irrationally high value after taking the rest of the loan sale execution into consideration, or, at the very least, at pricing that's higher than the originator values it himself.

The buyer who relies on that guideline compliance accepts the operational and financial risk he purchased, relying on the originator-seller to indemnify the buyer (who sold or securitized the loan with the GSE) if the loan is not made to the guide (reps and warranties).

We have seen what happens when the lawyers start interpreting these documents and repurchase demands overwhelm non-servicing originators who already spent the money that was expected to be banked for a rainy day this bad. Even those who did bank for the rainy day were overwhelmed. This phenomenon of "spent the money" was anecdotally more pronounced in those firms that did not possess servicing and had liquid assets that

were not necessarily kept in their companies than it was in traditional mortgage bankers who did service loans.

We have seen how originators have paid with their existence for loans to borrowers who ultimately could not pay and whose foreclosed properties produced losses that generated repurchase demands that drowned these firms out of existence, whether or not the repurchase request was on a loan improperly originated. The unsympathetic repurchase power is the natural outflow from the pricing power to purchase that the largest servicers wielded for years.

We have seen how the larger banks have recently reduced pricing to the street, because they implicitly recognize the pricing errors they made in the past but that they will not admit. This presents an opening for mortgage bankers to retain servicing under the current compensation paradigm. Many are. Many more wish to be able to do so, but find the logjam of the GSE approval process to be even slower than sympathy for the time it takes to perform thorough due diligence would lead one to expect.

For the years leading up to the 2008 meltdown, when the incentive of keeping a loan performing was superseded by the capital markets' pricing incentive to commoditize and the need to remain solvent with questionable balance sheet valuation in order to produce loans whose future performance is questionable, those questionable loans have the possibility to pull everything else down with them.

Underwriting sustainability should have signaled the coming tsunami of defaults. While it may or may not have to many, including the GSEs, regardless, business practices were not altered to prepare by all but the most observant – often mortgage bankers and servicers who were worried about missing the subprime production gravy train but were more concerned about the future quality of the loans they were producing and servicing, leading them not to partake of the market's easy money in the production of loans with lesser underwriting quality. The main players in Michael Lewis's "The Big Short" recognized exactly this questionable underwriting within the cadre of subprime loans that, 4-5 years ago, started the default crisis we are still in.

The GSEs' role in perpetuating subprime is beyond the purview of this response. However, the relaxation of underwriting in the mortgage business overall undeniably enabled increases in collateral value that fashioned a support level for the value of underlying houses… until it did not. Servicers got caught in the crossfire of underwriting that mortgage bankers were incented – by pricing, by government and then GSE encouragement, and by overall market forces – to relax more than was, in hindsight, prudent.

So how exactly does servicing compensation explain where we are? And how will a radical servicing compensation change in either form of FFS actually solve anything without effectively causing to exit a large number of existing small- to medium-sized servicers or without discouraging new mortgage bankers wishing to enter the business who have not gotten approvals, none of whom are/were the intractable operational or financial problem that existing larger servicers are? In other words, how will a radical servicing compensation change solve anything by removing customary-and-codified residual financial incentives to service loans properly in exchange for accepting the existing and widening regulatory burdens that go along with servicing mortgage loans? And to the assertion of removal of such incentives, we recognize that the academic attractiveness of “choice” and “options” and “flexibility” can make them beguiling. What if they are not, as we believe they are not?

When, under FFS, the option of monetization of the residual cash flow today can be had while accepting the responsibility of servicing, what is there for the GSEs to pursue as a remedy for improper servicer practices? Would “flexibility” prove to be prudent for the GSE, then? If the regulatory answer is to require more capital held by the servicer, how does that incent anyone of any manageable size to want to service for a paltry cash flow on performing loans, unless there is a good chance that loans will go delinquent and have a larger fee attached? If the regulatory answer is to require more capital, what will there be to go after but that capital? Wouldn’t a firm with more liquid capital have an incentive to pull that capital out of the firm in advance of the GSE execution of its remedy?

Or is the goal of FFS to wring out the smaller servicer from the business, even if that is the type of firm that is not the unmanageable problem for the GSEs, nor the type of firm that presented ubiquitous operational issues or took undue financial risks? FFS theoretically may provide optionality to smaller mortgage bankers in the capital markets, and proponents sell FFS as a boon to smaller servicers, but we have seen what optionality did when servicing a loan went from what mortgage bankers did to what someone else did after they paid the originator what has proven finally to be too much for it. FFS will simply change the movement of money within that commoditization dynamic and accelerate consolidation, not stand in its way or reverse course.

FFS, via the IO strip architecture, would lead to tax liabilities for the servicer as the originator/holder of that IO strip, not found with the current Tax Safe Harbor provisions if the servicer were to hold servicing assets. That will render a decision to hold IO in FFS not the equivalent decision to hold servicing rights under the current paradigm.

When the overall economy fell into the economic hole that housing created, the vicious cycle, whose end we are only now seemingly (and hopefully) approaching, had nothing

to do with servicing compensation and everything to do with capital markets compensation for servicing spread and accounting practices surrounding the servicing asset. In other words, servicing was, in hindsight, mis-priced by the very firms whose servicing practices are generally decried, occasionally unfairly, but whose size makes them unwieldy to unwind or control. Is that mis-pricing and inability to perform the function of servicing the fault of ongoing loan servicing compensation? Are we now here to protect those accepting the financial risk that they created by way of their own pricing power from themselves? We should think not.

Providing Flexibility for the GSEs to Manage Non-Performing Loans

After 10-20 years of no over-arching default issues anywhere in the country, such as that which we saw in the early 1980's in Texas, the mid-1980's in New England, or the late 1980's and early 1990's in California, default servicing capabilities had atrophied as large servicers worshiped at the altar of performing loan economies of scale and financial risk-taking. They certainly had specialty capabilities, but the amount of default loan servicing at any given time for the 15-20 year period leading up to the generally-regarded 2008 financial meltdown was miniscule relative to the amount of performing loan servicing on most platforms. What economy of scale could be had in a specialty that was regarded as an afterthought at the largest of mortgage servicers? We all know that it shouldn't have been regarded as such. And it never was an afterthought in those firms that have an existential worry if they do not originate or service their own loans correctly.

The pain of default servicing was felt at the expense level and the lingering-problem level, not at the existential level for any of these mega-servicers, whose servicing operations are, by default, being called into question. The large servicers have the high profile that makes them legal targets but also allows them to settle legal claims (such as the ongoing 14-largest-firm, originally all-50-state-attorneys-general settlement talks over foreclosure and default practices) and continue operating in places and circumstances where smaller servicers would need to cease operating. The cessation of operations would be the hammer that the GSEs would have over their servicers – until their servicers were no longer clients, but were, instead, peers or even servants to the masters whose growth the GSEs subsidized.

Smaller mortgage servicers have felt pain through this environment. Smaller mortgage servicers have not, as a group, been the ones who were the cause of the borrower service problem; the ones in need of a financial risk bailout-solution; or the ones for whom the GSEs need flexibility in managing, since the small servicers have a more acute existential risk should they perform any part of the loan servicing function incorrectly. Countrywide, Washington Mutual, and Wachovia paid with their existence, but via FDIC- or Treasury-orchestrated shotgun marriages. Now that Bank of America, Chase,

and Wells Fargo have done the taxpayer a favor, they are among the firms whose operational servicing practices are decried but whose financial risk-taking (ultimately with varying degrees of taxpayer money, no less) led them to this operational place.

Changing the servicing compensation paradigm to either FFS model would affect smaller servicers, who are not the operational or the financial problem – for the industry, the GSEs, or FHFA in general – disproportionately at the servicing level and likely so also at the secondary marketing level. Those servicers that present such an operational or real problem (as opposed to the substitution-of-quality-for-quantity-of-capital problem) under any compensation paradigm will pay for it with their firm's existence. So why exactly would changing compensation change that? Would a FFS servicer roll over for the GSE to seize the servicing for cause any more in such a paradigm because he would have less cash flow to lose? We would think not.

In initiating this discussion, the FHFA is conflating mortgage bankers' past improper-relative-to-actual-asset-performance capital markets compensation for and valuation of servicing cash flow with actual ongoing servicing business cash flow in trying to solve problems that the market is working its way out of, without changing anything.

It is that actual ongoing servicing cash flow that funds the business operations of full service mortgage bankers, big and small. Reduce that cash flow for performing loans, and increase cash flow for non-performing loans, and the old maxim "you get what you pay for" will come into play. And if "you" don't pay enough for the harder functions of non-performing loans once you start paying for them, servicing performance will suffer even more than it has in the current environment of overwhelming default loan populations.

The IO strip fashioned from the remaining spread under either FFS model will invariably have to be monetized by mortgage bankers in order to subsidize originations at the primary market (borrower) level, as bigger servicers force origination pricing to keep up with their lead on how to fund a continuously-growing servicing operation in feed-the-beast fashion.

We have already seen this with the rise of the wholesale/correspondent origination model in the 1990's. Rather than price through the (security) screen price and lose appreciable money on the origination in order to hold servicing and remain competitive on the primary (origination) level; rather than deal with the capital requirements of having this asset on the balance sheet themselves, many banks and mortgage bankers exited the mortgage servicing business, depriving many areas, ultimately, of the local servicer

option for fixed rate loans. Small, non-bank mortgage businesses and community banks morphed from being full-service mortgage bankers for secondary-market loans into servicing released sellers who simply commoditized the loan servicing asset. Better to sell servicing released and receive a pile of cash from someone willing to take a risk greater than these selling firms were ultimately willing to take for keeping it. Yet there are still hundreds and perhaps thousands of firms out there willing to service a significant percentage of their production under the current compensation paradigm. True, that number used to be in the thousands, for sure, in the early 1990's. However, a "relocalization" movement in servicing capacity would accomplish much in the way of borrower service. Reducing ongoing cash flow for servicing is hardly the way to accomplish such "relocalization."

So the FFS advocate may say that I am making their argument. "The capital markets can efficiently allocate pricing to an IO strip of this nature better than mortgage bankers can." Perhaps that is true in this case. But what does that have to do with "improving borrower service?" Where does that leave a mortgage banker who would like to service but who is unable to service, for example, for $10 per loan plus, let's say, 5 basis points of this orphan IO. The mortgage banker could make the decision to retain 15 basis points of IO, and that flexibility sounds great. Of course, the mortgage banker would have tax liabilities that would mute the willingness to hold the IO. In this example, the mortgage banker would have to forego cash value in order to fund an operation, or he would have to enlist a subservicer. At that point, under FFS, the mortgage banker could sell the paltry $10/month servicing asset for what he could and keep the IO, but why? Unless the market was egregiously undervaluing the spread, he's selling the whole thing and becoming a de facto broker, just as we lament that the business went to that commoditizing-the-origination model in the early and mid-1990's.

Why is it that "specialty" servicers (meaning default servicing specialists) emerged like weeds in the immediate aftermath of the 2008 meltdown? It is truly the case that incentives to allow a borrower to default will be in full bloom if you pay a servicer, of necessity, much more money to administer defaulted loans. New specialty servicers (or at least big money behind the purchase of older, smaller servicing platforms) sprang up because they knew they could either develop or market default servicing services to counter-parties, such as the GSEs, who had few options – which means there's a lot of money that would be flying around to attempt to solve the operational issue.

Such specialty servicers are out there now charging reportedly large sums of money per defaulted loan for highly-labor-intensive processes, even after being given pools of largely performing loans. These specialty servicers are negotiating from a position of strength, charging a lot for their default expertise that they are competing to receive, if

you can call having it given to you in a rotation of such special servicers actual competition.

Under any FFS model, theoretical indifference on the part of the servicer would mean that the monthly $10 per loan for a performing loan and a larger monthly per loan fee for a non-performing loan (recognizing that there may be some layers in how non-performing loan compensation would be established for various practices) would tilt the compensation-for-outcomes equation on its head. “We want loans to perform. We’ll pay you less for that because we know it’s easy. We know servicing defaulted loans is difficult. We’ll pay you more for that.” How long before the profit motive to get to the larger non-performing loan fee leads to loans simply being allowed to default? How long before the pursuit of the larger non-performing loan fee under FFS leads servicers to originate loans of more questionable underwriting with a greater likelihood of defaulting or to compensate sellers for their originations of such loans? We can all agree that defaulted loans, while a reality, are something to be minimized, right?

Fannie Mae representatives have said, in slightly varied forms, on multiple occasions in discussions and webinars, “We’re not saying that you have to take this lower servicing spread. You can keep 25 basis points still, if you want. We’re offering you flexibility.”

While the flexibility label is only somewhat plausible from an academic point of view on what is being proposed in the form of fee for service, it is an article of faith that greater flexibility to choose to service loans would necessarily emanate from a FFS model. A new class of IO strip asset may seem like a great idea, but ultimately a universe of servicers will have to be prepared to service for $10 a month. The IO strip is a sure-to-be-commoditized afterthought under both FFS models, because it is not totally attached to the servicing right itself, granting that FFS Option A has a tether to the MSR, and holding it has a different tax treatment than current MSR asset tax treatment.

We have a group of subservicers out there who are already operating under a contractual fee for service paradigm – which begs the question, why are there so few firms trying to enter the subservicing business and become de facto fee for service providers now? If FFS is such a great model, why has no business entered as a pure fee for service, soup-to-nuts subservicing provider in the last 4-5 years, with one exception, that flamed out and effectively exited the performing loan subservicing business (but stayed in the specialty servicing business)? Why is it that we can count many mortgage bankers who have entered the primary servicing business in the last several years, with many more clamoring to get their GSE approvals to sell and service directly for one or both of the GSEs? Why wouldn’t existing specialty servicers view FFS as anything other than a way to bake defaulted loan compensation and deal flow to them into the cake that inures to their general benefit? We all advocate for our own position, which is fine, but when such

specialty servicers find themselves as the ones managing the initial deluge of defaults 25-75 years from the end of the current crisis, after a period of relative calm where their expertise may not have disappeared, but their volume capacity will have diminished, wouldn't it follow that they would be the ones able to dictate terms of special/non-performing servicing loan compensation to the GSEs rather than the other way around? "We can do this, but you aren't paying us enough to do this much... Pay us more if you want this population of loans to be worked through appropriately."

If the retort were that such a situation has happened to the GSEs already under the current compensation paradigm, the problem ultimately is that we got a deluge of defaults, and the industry could not keep up with the sheer volume. If a discipline within the servicing business is relatively unused for decades, where would the expertise actually be to get in front of that tidal wave for the benefit of mortgage investors AND borrowers, BUT for compensating for performing servicing in order to build up a war chest to maintain a default servicing department and to have something of value to themselves to defend against GSE remedy, in a business sense? If the regulatory or GSE response is that requiring firms that service to hold significantly more capital than they must already, then servicers would be that much more incented to monetize everything in the capital markets, while receiving a paltry cash flow that would present no appreciable return to any but the biggest of servicing firms, that would lead to the super-consolidation of the servicing business that we strongly wish for the FHFA to avoid fomenting with a move to FFS in either form.

As with what happened in the 1990's and extended into the 2000's, "choice" and "flexibility" will be a way to force more of those mortgage originators who still service loans or who otherwise may decide that they can keep servicing under the current compensation paradigm, to monetize everything they can and not bother with servicing, especially under FFS Option B in the Discussion Paper. The "choice" will be no choice at all for many existing mortgage bankers or for banks or credit unions that would contemplate entering the GSE servicing business. In the event that the market undervalues the IO strip in a FFS model Option B from the Discussion Paper, sure the mortgage banker can hold the strip without having to service the loan. We suppose that could be construed as flexibility. What would that have to do with improving borrower service? Incenting mortgage bankers to concentrate overall industry servicing operations into fewer hands is what led to the inundation of servicing operations with defaults that they could not manage. What would that have to do with providing the GSE flexibility in managing default servicing when they have less options of qualified servicers to move the loans to? After all, the platforms of the largest firms that failed – Countrywide, Wachovia, and Washington Mutual – have new ownership, but the platforms are generally still in use. Thus, the problems of their lack of flexibility in addressing non-

performing loan management issues that the GSEs wish to solve are that much more intractable to deal with at those organizations.

<u>Other observations</u>

- It's interesting to note that Fannie Mae actively advocates for servicers to keep more of the ostensibly "flexible" amount of "skin in the game" via retention of a higher servicing fee on the part of its servicers in the multifamily servicing division. However, it can only cajole rather than force that issue on its servicers… The FFS paradigm would very likely put the GSEs in the position of cajoling its residential servicers to hold some of the IO strip as described in the Discussion Paper.

- It strains credulity that servicers much smaller than top 25-30 would continue to service loans if servicing compensation were to be changed to a FFS paradigm… Via the capital markets, the biggest servicers would wring out the spread on the orphan IO at some point in the FFS Option B from the Discussion Paper to virtually nothing; or the GSEs will set the market at the guaranty fee buyup in FFS Option A from the Discussion Paper, which, if recent history is any indication, will be far lower than the private market. The latter may actually have a benefit if the GSE buyup is low and by setting the value, muting the tax implications (i.e., a lack of tax Safe Harbor treatment) of redefining the servicing spread as IO. However, that series of events would lead to borrowers paying more upfront (or conceding more in interest rate via primary-secondary spread) in order for mortgage companies to profit from origination.

- We live in a world where Pareto's Principle (the 80/20 rule) holds. The servicing business for secondary market mortgage loans used to be that way, with approximately 80% of the population of servicing rights being handled by approximately 20% of the servicing firms. The pursuit of efficiency has been blinded to its errors in the pursuit of market-share. Now we have a servicing business where Pareto's Principle doesn't hold. 80% of the servicing is handled by less than 1% of the servicing firms. Much of this consolidation has been the result of those larger, market-making individual firms' pursuits in the secondary market, and the last of the consolidation was the result of being the last ones standing when government agencies needed these too big to fail firms to take these companies' operations over virtual weekends. A FFS paradigm will consolidate the servicing business and cloak its advocacy in flexibility for smaller firms. The implication is that such flexibility will attract new servicers. The much more cynical view is that the FHFA is trying to get the business back to an 80/20 business by making servicers exit so that the approach to 20% is

accomplished by having fewer firms actually servicing secondary market loans. That could hardly be called healthy competition.

- Note that so much of the argument against FFS that we are presenting actually revolves around origination and secondary marketing incentives and considerations, because the servicing right in the FFS model, in the end, is assumed to be worth little in a business sense to all but the self-regarded most efficient payment processors – who are the very firms that proved that they could not handle the non-performing loan processes that were the outgrowth of that "efficiency". If "efficiency" comes at the expense of dotting i's and crossing t's, what kind of efficiency is that? Note that one of the firms involved in the "robo-signing" processes that epitomize the borrower service problems is one of the firms pursuing subservicing contracts most aggressively under the current compensation paradigm. While it would be unfair to say that they were "robo-signing" on behalf of their existing subservicing clients, their pursuit of subservicing speaks volumes as to the relationship between "efficiency", "competence", and "borrower service." And why would anyone want to make it easier for such firms to continue their growth because they are the ones that got big enough to be able to deal with much smaller required compensation and who are most aggressive in their exploitation of accounting artifice surrounding an asset that is so volatile? If the MSR at FFS of $10 per loan per month is assumed to be worth little, but existing "special servicers" seem to be clamoring for FFS, what does that tell you about their profit motive and expectations for what non-performing loan compensation will be, or at least will be forced to be? Default servicing is the business that they are in, but why would special servicers generally advocate for FFS models which would bake base fees for default servicing, unidentified in the Discussion Paper into their businesses? Why would large servicers generally be indifferent or at least more muted in their criticism of FFS in terms of business cash flows (though perhaps highly critical in terms of accounting and tax implications)? And why would small-and-medium-sized servicers generally be screaming against FFS? I say "generally," because there surely are specific-firm exceptions to these generalizations – though they seem to be few and far between. Why are those in the business who generally want no change at all the ones who would bear the operational and financial brunt of a FFS servicing model but who did not operationally or financially present intractable problems for the servicing industry, economically or politically or for GSE management? Why are those few who are not special servicers or subservicers already, but who advocate for FFS, firms that are primarily origination factories that sell servicing released and have little interest in servicing as a business operation or an asset? We all have our own interests at heart, of course. But if originators who are constantly selling whole loans servicing

released as much as possible already could see an exploitable advantage in the originations markets via FFS, what does that have to do with the business of servicing and compensating for servicing functions? If special servicers clamor for FFS, and by definition, they profit more at the societal expense of more defaults, would it not follow that FFS would incent practices of inaction on the part of servicers vis-à-vis stressed-but-performing loans? Isn't that the very definition of poor borrower service that FHFA seeks to improve?

- When talking with GSE advocates of previous radical iterations of service fee changes in spring 2011, after a free-wheeling discussion of the pros and cons of the status quo vs. a minimum service fee architecture of 3-5 basis points, the advocate's parting shot to me was, "What do you think the big guys really want?" The implication of the question at the conclusion of that conversation was that the top sized group of servicers generally (not universally) wanted a minimum service fee of 0.125% under the same kind of contract under which the industry operates now. Such a reduction in minimum service fee would change operational compensation to something under which the largest servicers could operate comfortably, unlike many smaller servicers, while allowing them to exploit all of the same accounting rules and capital markets considerations that are the genesis of the problems FHFA is theoretically trying to address. For many of the same industry consolidation reasons we wish for the industry to avoid continuing and then roll back, we do not advocate for FFS in either of the Options described in the Discussion Paper, and we have a visceral reaction to the longer-standing proposal of a simple reduction in minimum servicing fee of 0.125%. After understanding some of the potential attractiveness of that 3-5 basis point paradigm to smaller servicers, we came to the conclusion that the existing large servicers would compensate the correspondent market to their own ends of obtaining a 0.125% servicing fee. What's to say that that would not be the case with FFS? The Clearinghouse Proposal in the Discussion Paper doesn't have a performing loan service fee of 0.125% for nothing.

- When speaking with GSE advocates for radical servicing compensation changes on the level of consolidation worries, one in particular made the statement to the effect that, "If you can't service for a certain dollar amount of X, I'm not sure I want you servicing for me." Really? If that indeed is the case, how is it that many of the servicers who actually "can" service for that X dollar amount are the exact firms that presented borrower service problems through this default crisis and are the exact firms that the GSEs have the hardest time managing, because they are so large and are the exact firms whose balance sheet size and MSR value present the exact financial risk of their own making that we are discussing as a problem?

- The origination/servicing released secondary market is changing in many ways in this environment, and it is still functioning. Mortgage bankers are taking the opportunity to regenerate or start servicing portfolios themselves in this changing environment. However, the secondary market for naked servicing rights (that is, the servicing asset created after the whole loan has been sold or securitized) is seized up and has been for the last three years. This, however, is not a reason to make a change to FFS.

  The evolution of accounting rules from FAS 65 and 91, where servicing went from an off balance sheet to item an on balance sheet item, depending on whether the servicing was on an originated loan or a purchased loan, to FAS 122 which removed that absurd distinction and required all servicing be on a firm's balance sheet, to FAS 125, 133, 140, 156, 157, and 159, which all tried to deal with arcane servicing asset issues created by the FASB's insistence on removing the originated and purchased servicing distinction. However, all of these rules served to tame a key parameter in establishing balance sheet value – the market itself.

  In the service of reducing borrower upheaval entailed in a servicing sale months or years after the origination of a loan; and in the service of keeping mortgage firms from the whims of the volatile servicing market in terms of maintaining their liquidity, the FASB embarked the business on a path toward the "no market" that we have today, because with more rules came more opportunity to consolidate market-share on the part of those firms with the desire to grow and crawl into the arcane and opacity while the FASB claimed it was creating rules for transparency.

  MSRs are indeed a valuable asset. They also are, by their nature, volatile in their valuation. However, when the market for the asset itself tames, and those holding the bag possess an asset on balance sheet for which there is "no market," how do those firms remain solvent? Via a "fair value" hierarchy which says that fair value is market value except in the absence of market, at which time the claim of "no market" can almost always be made by those who hold the asset at values serving their own accounting ends and, sometimes, needs.

  Pile on top of that, the very representations and warranties made by the seller-to-the-GSE, indemnifying the investor, that are supposed to ensure good underwriting, have been exercised in places big and small in the last 3-4 years, primarily for loans made in the years 2004-2008. The GSEs' issuance of a repurchase request is the attempt to exercise that indemnity. In many cases, with good reason. Anecdotally, in many cases, bad loan performance on loans

underwritten to the guide provided to the originator become repurchase requests to defend, and when the counter-party making the claim is plaintiff, prosecutor, judge, and jury, there are those times when servicers must repurchase the loan anyway just to make the issue disappear. The chain of indemnity runs from the GSE to the current servicer only. In servicing sales, the buying servicer has to exercise its contractual rights down through the chain of its counter-party (the prior servicer or prior originator) who sold the servicing or the loan to the buyer, and there may be multiple priors on an individual loan. If the prior servicer or prior originator does not indemnify, either willfully or because the company has closed, the servicer is holding the bag and must defend successfully or indemnify the GSE.

The crisis saw many mortgage bankers and brokers close their doors, either by necessity or choice, rather than indemnify their buyers. If you are the servicer, that is obviously not a good thing. In a declining home value market, with defaults piling up, the prospective repurchase losses (and default servicing costs) – even on the servicing of the best-performing of loans whose fate is uncertain in such a sluggish economy – given the anecdotal behavior of the GSEs exercising their contractual rights in a very aggressive manner, why get involved in buying servicing unless you can get a huge return and protect yourself in price with a seller whose ability to indemnify was in question? Unless you can get the GSEs to bifurcate the representations and warranties – which has been done, but is an expensive and difficult-to-negotiate proposition for a seller.

The only pure servicing deals that are being closed in this environment with any regularity are either liquidation sales, where the seller had no choice but to sell or have its assets seized by the GSE; or sales of flow (newly-originated) servicing, either with representations and warranties bifurcated between originator and buyer or with the buyer accepting representations and warranties from only a highly-capitalized, well-qualified seller, with underwriting qualifications that are even higher-than-traditional GSE underwriting.

When will that change back to a more traditional, less discriminating without being imprudent market? We believe that the servicing market will stabilize when the overall economy recovers substantially, particularly in the housing market and in employment markets, and when the market value of the servicing assets to a third party will ultimately match their worth on an ostensibly economic basis to a seller. Protecting in price or even not getting involved in a naked servicing purchase are very much the reasons that the servicing market has seized up, and there are certainly rational reasons the market has come to that. Buyers and sellers in this space have been screaming across a canyon rather than sitting

across a table from one another in terms of what kind of pricing would work for them respectively.

Bifurcation of representations and warranties would change from the current contractual paradigm of rolling indemnification downhill from the current servicer through the priors, with the current servicer being the ultimately responsible party to the GSE; to the GSE looking to each individual firm in the chain for their actions or inactions to pursue its indemnities. We happen to believe that this bifurcation would absolutely help servicing market liquidity right now. However, in a more stable real estate market and less volatile overall economy, such as we at least appeared to have had in the 15 years or so preceding the 2008 financial meltdown, bifurcation would be a far less meaningful-, if not irrelevant-to-the-market, proposition, but for the memory of its presence in this discussion.

Hence, it is our belief that while bifurcation of representations and warranties would help the market for servicing, the hand-wringing of the FHFA and the GSEs over this issue could easily be handled with bifurcation being a base-guaranty fee increase menu item for each servicer, rather than trying to use it as a sweetener for FFS. Bifurcation as a credit risk menu pricing item in the guaranty fee negotiation could be done under any servicing compensation construct. Those for whom flexibility to sell servicing later would be important, in fact, would have it at their disposal to make it easier or more difficult on themselves to sell, depending on the market environment, by making a choice at the secondary marketing of the loan. If, for example, optional bifurcation would mean that the seller at the traditional secondary market level could accept current representations and warranties and the market's reaction to them, with the seller paying his current guaranty fee, say 18-20 basis points; or the seller at the traditional secondary market level could accept paying a higher guaranty fee to the GSE, say 28-30 basis points, and having the ability to sell servicing to a buyer who no longer has to concern itself with the originator's representations and warranties.

Why that kind of bifurcation architecture needs to be considered only by the FFS model proposed in the Discussion Paper and not by both versions of both the Reserve Model and the FFS model in the Discussion Paper OR even on its own with no changes to the current servicing compensation model is extremely confusing.

Bifurcation presumably would benefit the GSEs or other guarantor organizations. They would receive bigger guaranty fees for taking the same credit risk on

individual loans that they ultimately would be guaranteeing anyway, all while receiving more cash flow compensation for the guarantor risk that they are taking, while having a more diverse set of counter-parties from whom to seek indemnification redress.

Bifurcation is reportedly available on a negotiated basis from the GSEs already. However, the ticket for entry into such a negotiation reportedly is a net worth of the company seeking such a bifurcated contract is $15 million. The need for bifurcation at that point is quite a bit different from the need for bifurcation of representations and warranties for a smaller firm. If bifurcation is the standard that the market is screaming for in order to liquefy the servicing markets, what makes that kind of net worth stand in for a need for ultimate underwriting quality?

- While we advocate for no change in servicing compensation at all, as stated previously, we strongly believe that if any change is so necessary that it needs to be made in the face of the market already adjusting to the economic realities of the housing market, the capital markets, and the regulatory environment, the MBA's version of the "Reserve Model" , with 20 basis points paid for performing loan servicing functions and 5 basis points held aside for the performance of non-performing loan functions or the payment for good performance of underlying loans best approaches the combination of goals laid out by the FHFA, in the best fashion for all market participants – mortgage bankers, mortgage/MBS investors, the GSEs, and borrowers.

- Do we as an industry and as a country want better servicing outcomes? Or do we simply want to tilt the origination business to more ubiquitous commoditization to result in fewer servicing providers to regulate, so that they can hold the GSEs and mortgage investors hostage to their need for more compensation when a default-stressed environment dictates that the servicing community cannot accommodate the outcomes we all agree are desirable, at the compensation they receive.

- The existing servicing compensation paradigm, with a customary servicing fee earned by the servicer of 25 basis points for conventional loans, is the worst servicing compensation scheme that one could conceive of… except for all the others.

Responses to FHFA's Direct Questions from the Discussion Paper

The questions asked in the Discussion paper are reproduced in red below, with our answers immediately below each respective question. Without limiting our advocacy for the positions that we are presenting, our responses are a combination of our own and some edited and unedited responses of other parties interested in and responding to this Discussion Paper.

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

If a change is required, the MBA's Reserve Model would preserve the current competitiveness in pricing and supply in the origination markets and enhance competitiveness in the servicing market. It would impact service to borrowers positively while tweaking what is already a proper alignment of servicer interests and compensation with those of the mortgage loan investors and the GSEs. It would preserve already-efficient TBA and mortgage-backed securities markets with a tweak instead of a categorical change in the compensation of the servicer-investor relationship, giving comfort to the market that servicers will have "skin in the game". It would maintain and enhance a compensation architecture that allows smaller mortgage servicers to compete successfully in the business of servicing.

The FFS proposal would radically change the balance of mortgage banking, in a codified, rather than market-dictated way, from equilibrium between origination and servicing to a market that is heavily weighted toward origination and commoditization of the resulting assets. The value of the business of servicing would be depressed and tilt business considerations in the direction of large and less controllable servicers, including in the direction of default, specialty servicers, whose specialty, of necessity, will allow them to hold GSEs and markets hostage to payment of larger fees, as they are now, the next time a default crisis hits the country in 25-75 years. The new-asset-class orphan IO strip that would be created will have a highly uncertain value and will destabilize markets for years while trying to find equilibrium that the markets are already finding under the current model. If the problems that FHFA is trying to solve are servicing related, how does changing the secondary market compensation for assets do anything to attract more firms into servicing when capital requirements qualifying a servicer are bound to increase, when regulatory compliance burdens are unknown and sure to present higher costs, when the notion of holding the orphan IO strip will have less benefit because of upfront tax implications, and when the notions of profit motive for all servicers fly in the face of adequate compensation architecture?

The lack of servicer "skin in the (business of servicing) game" in FFS will indeed call into question the servicer's motivation to protect the investor of the underlying loan from prepayment. Making rules to try to influence servicer behavior are fine, however, substituting capital requirements and operational maxims for prudent business practices will mean that less-desirable servicing practices will continue by larger, less controllable parties, whose interests will be less aligned with investor and GSE priorities and whose penalty for non-compliance, if exercised, will be less painful, even in the face of the most draconian of rules.

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

There are benefits to having a capitalized MSR asset. However, the mid-1990's implementation of the FAS 122 rule to address an operational inefficiency (not to mention borrower inconvenience) inherent in discovering an unvarnished market value of MSRs, which could confer cash value on balance sheet to a seller and an MSR asset on balance sheet for the buyer, led to consequences that we are seeing now in the institutions generally regarded as "too big to fail" in the mortgage business. As inefficient as that old system may have been, the establishment of market value was very transparent. The health of servicing as a business was apparent, except to those firms who took risks in origination that enslaved them to servicing sale results that exposed them to market volatility that sometimes did not work out. FAS 122 allowed such firms to ride out rougher markets, but at the expense of valuation transparency available via a vibrant if imperfect market for "naked" servicing assets.

After FAS 122 implementation, monopolistic pricing practices further subsidized by the GSEs in favorable guaranty fee pricing for the largest firms in the origination-and-secondary markets consolidated the overall book of servicing up to the top even more than plain efficiency would dictate, because while the accounting rules starting with and since FAS 122 are cloaked in "market value", the actual value paid and recognized was quite opaque to the origination and secondary markets, and became more so as time went on. Competing with such opacity is a problem for smaller firms who need to answer to both shareholders and auditors/regulators about their balance sheets, while having existential worry, and while competing on the street at origination with pricing that bears little resemblance to their own pricing realities.

FFS theoretically wrings the balance sheet implications of the accounting out of the servicing business for such firms, but only if you assert that MSR in a FFS model is not an asset (or liability) required to be accounted for. Under none of the proposed servicing compensation changes has the FHFA proposed a structure that would result in no

capitalized MSR. MBA Reserve Model capitalization would resemble current capitalization paradigms, mostly because the changes to compensation are modest and alter timing, not significant cash flow. FFS would not change the volatility profile of servicing capitalization for the better for any servicers, except in that the highs and the lows of value would be different and perhaps closer together, but much more volatile.

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

   Only to the extent that accounting artifice provides incentive to those willing and able to exploit accounting to their own growth ends, with few remedial repercussions to their businesses, at the expense of more modest providers who have existential risk. Only to the extent that true guaranty fee parity does not exist, providing the largest mortgage bankers the means to price advantageously to the origination market and opaquely to their balance sheets. Guaranty fee parity among all sellers to the GSEs would go a long way to solving the competitive problem in the servicing markets via the origination markets – much more than any FFS model that would substitute cost efficiency for competence as the reason for firms to grow. Yet it is the competence issue that the most cost efficient or aggressive servicers have, understandably, had to answer for. Willful incompetence is different, yet the effect of this incompetence, regardless of its root, is the same.

   The reason that heretofore exclusively servicing-released mortgage bankers are now clamoring to enter the business of servicing loans now is that they are able to calculate a benefit to holding servicing that is in excess of what the traditional correspondent buyers have been paying via their total execution. It is not a capital consideration in most cases, in this market, that causes mortgage bankers to want to service. It is a market-driven, business-value decision that is driving mortgage bankers to hold servicing now, if they can (via being GSE approved). Diversification of counter-party risk would surely help the GSEs manage their guarantor obligations much more effectively, and this market development should be encouraged rather than stunted, and guaranty fee parity among all servicers is the most effective way to accomplish such diversification.

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

   Not on the capitalization issue, it does on the cash flow issue.

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

The impact of capitalization of MSR 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 if the servicing will cash flow and provide a strong enough return vis-à-vis selling released, and also if regulatory considerations for balance sheet stability are not so tethered to a punishing or exuberant market value on the day that the actual value is calculated. Smaller servicers who abandoned the servicing business years ago for cash flow (i.e., for being compensated by aggregators well in excess of individual firm's economic benefit of holding servicing), regulatory, or pain-of-managing capitalization and accounting reasons are noting that less capitalization pain springs from having to commit less book value to the servicing asset. This observation comes from banks and mortgage bankers small and large.

To compete in the environment created by FHFA's FFS proposal, a servicer would have to have a large portfolio of relatively homogeneous loans with high economies of scale. Also, those servicers with large proportions of their operations in India would enjoy huge advantages. This is not in the national interest and would clearly be a disadvantage to medium and small servicers.

FHFA's FFS proposal would lead to further industry consolidation and further concentrate counterparty risk into the largest institutions, contrary to FHFA's stated objectives.

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

Perhaps, but MSR valuation rests primarily on estimates of the prepayment speeds of the underlying mortgages, and each company's assumptions that underlie the determination of those estimates and of other assumptions will vary. The "fair value" architecture of FAS 157, which allows for unobservable inputs to justify a fair value in the absence of market is one of two pillars that are contributing to a market so tamed as to be in virtual hibernation, the other being representations and warranties/repurchase exposure. Further, the "how" of valuation is quite transparent already. The differences in opinions as to value are where the distinctions between transparency and homogeneity-of-value are lost in a

fair value world, but where market value is established in a functioning market. Further, the implication of the question is that FFS would confer greater transparency in MSR valuation than the current compensation model. That is hardly the case, when FFS would still result in some form of asset or liability that needed to be recognized on the books, which would be subject to all of the same kinds of assumptions and differences of opinion that contribute to a lack of homogeneity which apparently is a perceived lack-of-transparency in differences in fair value.

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

A reduction in the tax Safe Harbor increases the likelihood that mortgage servicers whose cost exceed the reduced Safe Harbor limits face a greater likelihood of an IRS audit to prove that cost OR would mean that the retention of IO would be approximately 40% more expensive than retention of MSR under the current model. That would not be an inducement to greater retention of MSRs by mid-sized and smaller servicers who might face that exposure by holding IO to fund operations.

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

This question sums up the disregard for the loan servicing function that has marked this entire exercise. Yes there are financial and financial management aspects to mortgage servicing and to the MSRs that lenders acquire. But at its heart loan servicing is about providing service to borrowers, investors and GSEs. Obviously each party is owed different services by the mortgage servicer, and each party expects and deserves a high level of service from the mortgage servicer. The compensation for the MSR aligns the servicer's interests with the guarantor, which should be a good thing from the guarantor's perspective. Capitalization is certainly an issue whose answer has been settled for years, but not in the way that we believe it should have been for the health of the business. Value of compensation in the tank and unrealized was far better to keep that business alignment sound without blowing up asset bubbles that were created by the dichotomy between pursuit of capital and efficiency and pursuit of operational competence. Don't we wish as a society that that competence were there when the deluge hit?

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)?

   Contractual attachment to the MSR better aligns the servicer's interests with the GSEs. While a stand alone IO appears very attractive, we anticipate there would be a cost to that feature in the form of higher net worth and/or collateral requirements for servicers, poor market value and relatively illiquid markets for the IO. The tax disadvantage to retaining the IO makes that an unlikely option for an independent mortgage banking company.

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

      Since this new asset class of IO derived from a strip of income is not now traded independently in the market place; it is hard to predict. It is quite likely to be illiquid, regardless of mortgage banker. It is quite likely to be a "Type III" asset under accounting rules, because of that illiquidity. Size of servicers and originators as a factor for variance is primarily a question of volume's effect on outside investors. In other words

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

      We believe investors will be quite hesitant to purchase these IO strips. That will lead to poor pricing from outside investors and perhaps the GSEs being the only purchasers, which will almost certainly ensure poor pricing, although such poor pricing would also be transparent. If taken as a way to argue for holding IO, the tax treatment of the IO (without Safe Harbor) would mute any willingness to hold IO.

   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?

      FFS would absolutely be harmful to the industry of servicing loans, tilting incentives to servicing performance, as attached to MSR incentives, into rules and regulations promoting servicer indifference as to outcomes while requiring capital levels that will lower profitability of servicing. FFS would tilt the incentive structure of the entire business to the

commoditization-at-origination end of the equation, to the detriment of the servicing function. Financial management activities surrounding an illiquid IO plus financial management activities of a different-style of MSR would simply change the nature of financial management difficulties, not simplify them. FFS as a beneficial structure could only be regarded as such if you believe that the servicing function in the mortgage banking business is a general afterthought. It may have been pretty sleepy for 15 years, but when it became an important part of the business, ask yourself if FFS were the model in 2004, at a compensation level to be determined by the GSEs once a year, would have changed the outcomes for borrowers to the better, to secondary market mortgage investors to the better, or to the GSEs to the better. The answer to all is unequivocally no.

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

It is very difficult to answer this question without more detail about the services expected on non-performing loans ("NPL") and the fees to be paid. Based on the limited information available it would appear that the Reserve Model holds the promise of incenting greater investment in such operations, much as recent experience likely would chasten servicers into maintaining default servicing capacity much better than they have under the existing servicing compensation paradigm. The details of NPL compensation, however, would be a critical factor in assessing how to answer this question. In any event, if you take the 15 years leading up to 2008 and consider that many of the default servicing departments at the biggest servicers had atrophied so much, presumably because they were not getting paid to keep them up explicitly but also because we were in that benign market cycle, what, in the FFS proposal in particular would lead anyone to believe that NPL operations would be robustly invested in, any more than they were before?

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

The FHFA's FFS proposal puts guarantors at great risk by reducing the value of the collateral (MSRs) that will be available to the guarantor (the GSEs) in the event of a servicer failure. No "skin in the game" would allow an at-risk servicer that much more of an ability to shrug his shoulders, because there would be much less for the servicer to lose of value. Over the lives of the GSEs, there have been many instances where the only thing of value at a failed institution was the MSRs, which could be seized by the GSEs and sold

at fair market value. While that is hardly an optimal scenario, at least there is something of value to be had with a string to the GSE under the current paradigm or the Reserve Proposal.

As mentioned before, the FHFA's FFS proposal will lead to further consolidation of servicing with a few very large servicers. The concentration in "too big to fail" institutions will greatly increase the GSEs' counterparty risk.

b. Would this improve service to borrowers?
If, by "this," the question refers to either FFS servicing compensation construct, the categorical answer is no. It's hard to imagine a scenario where reducing the cash flow and, by extension in this case, profits of a business will improve the quality of service to borrowers. History is littered with economic "planners" building a better mousetrap and expecting better outcomes, only to find that the mousetrap is pretty hard to improve upon and that the improvements actually made things worse. The FFS paradigm has the hallmarks of such planning. Reducing explicit compensation for servicing and replacing it with either upfront monetization of the cash flow or an IO strip asset related by underlying mortgage asset but divorced from the actual requirements of servicing the loan defies logical economic analysis.

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

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 Model represents modest changes, and arguably though not necessarily, enhancements, to the current mortgage servicing compensation model, we do not believe there will be very much impact on the TBA market.

The very 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 ultimately bifurcate the TBA

market and reduce its liquidity – which ultimately would mean higher interest rates borne by borrowers under an FFS model.

This question implies that a proposal has been made that would result in no MSR capitalization. The FFS proposal will result in capitalization of either and asset or liability that will have duration and convexity attributes very similar to current MSRs. Simply changing the life of loan contract to fixed dollars from fixed basis points does not change the accounting requirements. The fact that the MSR asset will look dramatically different in a FFS model and will tilt the balance of the business from a recognizable-to-the-TBA-market origination/servicing equilibrium to an origination-fee-driven model, the TBA market in an FFS model world would be much less liquid (and thus, higher-priced) with a more prepayment-driven mortgage banking model than the current compensation paradigm presents.

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

   The fundamental overriding factor the TBA market will focus on is that mortgage servicer's compensation for servicing loans and their resulting investment in that income stream will be largely unchanged in the reserve option and greatly reduced as income and eliminated as investment under the FFS model. The net tangible benefits test will not balance out that concern, which will be perceived by the markets as increased future prepayments.

   Borrowers have long established their own tangible benefit test when considering refinancing. The interest savings needs to be enough to justify the up-front cost; otherwise the homeowner would elect not to refinance. A formal tangible nets benefits test will put all loans on the same footing, including those that added costs to the principal and ignored those costs in the past.

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

   Presuming that "additional steps" truly have to be taken for whatever reason, economic or political, adopt the MBA's Reserve Model.

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?

      We believe this would be beneficial to the market by making the responsibilities of each party independently accountable to the GSEs. We also believe that this is a change that could be made as a guaranty fee menu item and which could be implemented in any servicing compensation paradigm – current, either iteration of the Reserve Model (MBA or Clearinghouse), or FFS.

   b. A net tangible benefit test for streamlined refinances?

      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. Borrower protections are important, but we believe that borrowers know when refinancing is to their benefit without a test rooted in a bureaucratic value system or worth completing given their own financial situations. A net tangible benefit test that has a way for the borrower to continue to pursue a streamlined refinance even after finding that the borrower is not part of the hypothetical group that would "benefit," while providing a way to "prove" the benefit that borrower seeks is not bad, in theory. The problem ultimately becomes a question of where the line is drawn. What's interesting to us – this is not really s servicing compensation issue, is it?

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

      This sounds like a big "so what" for the servicing compensation discussion and very much a TBA/MBS market disclosure consideration.

      With such disclosure, the markets will impose a practical limit on how much IO could be kept in a given pool.

   d. Limitation of P&I advance requirements?

      A 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 an important cost factor and plays a role in the determination of the amount of MSRs that are retained as opposed to sold.

e. Flexibility for excess IO execution?

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.

A substantial MSF, such as the MBA's 20/5 Reserve Model, removes this uncertainty for the servicer and protects the tax advantage of the MSR versus IOs-plus-FFS servicing.

We again would like to thank you for the opportunity to respond to the Discussion Paper.

Best Regards,

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