COLONIAL
SAVINGS

December 1, 2011

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

Dear Mr. DeMarco:

Please consider this Colonial Savings, F.A.'s[1] response to the FHFA's recent discussion paper (Alternative Mortgage Servicing Compensation Discussion Paper Dated September 27, 2011) on servicing compensation reform. The paper provides a basic outline of two alternative approaches under consideration that might replace the servicing compensation structure that currently exists for conventional residential loans owned or guaranteed by the Government Sponsored Enterprises (GSE's), Fannie Mae and Freddie Mac. The paper identifies a number of different objectives that FHFA hopes to achieve through its Joint Servicing Compensation Initiative including improved service to borrowers, reducing financial risk to servicers, providing flexibility to guarantors to better manage non-performing loans, and promote continued liquidity for TBA for GSE MBS. Our response will concentrate on the Fee for Service proposal as to whether it would achieve the stated goal. We don't think that the reserve account option is much of a benefit to anyone, but if a change must be implemented, we view it as far superior to the Fee for Service plan. Finally, we will offer some alternative ideas to expand the pool of mortgage servicers and enhance the Guarantors ability to manage non-performing loans.

Is the Problem Really Servicing Compensation?

Presumably, in issuing the paper proposing to change the model, the FHFA believes that the existing servicing compensation structure was somehow flawed and that flaw contributed to the mortgage "crisis". We believe that the "crisis" was not caused by servicing practices but rather by poor underwriting decisions driven by "irrational exuberance" on the part of a wide spectrum of constituencies including borrowers, mortgage lenders, brokers, appraisers, MBS investors and investment bankers, as well as all levels of government including Congress and housing regulators. In the best of circumstances, players failed to consider, much less attempt to rein in, the unsustainable rate of appreciation of housing prices. In the worst cases, fraud and misrepresentation distorted market reality that would have otherwise helped control price increases. All of these factors over-promoted housing and allowed traditional underwriting approval criteria to be lessened or eliminated altogether. The momentum for expanding mortgage

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credit continued until a tipping point was reached and the market crashed in its own excess. The mortgage servicing industry didn't participate in the cause of the crisis, but now is left to clean up the mess. The real culprits, "Fast and Easy" mortgages with reduced or no qualifying documentation and the companies that promoted them are gone. Traditional standards are back in place and thanks to Dodd- Frank such products won't return.

We have participated in several meetings and conference calls with the FHFA and staff from the GSE's. It is quite clear that the FHFA and at least Fannie Mae favor the Fee For Service (FFS) model. We believe that adopting that model would be disruptive to the marketplace and are unconvinced that the any benefits outweigh the disruption. How could such a dramatic change be implemented without complete certainty that the new structure will have sound positive improvements? We believe that the FHFA's paper fails to present a compelling argument for why and how a change in servicer compensation will achieve the stated goals. In fact, we believe that the only goal that might be achieved is the reduction in financial statement risk to servicers by eliminating MSR's at the risk of destabilizing mortgage companies in the future, and even financial statement risk can be mitigated in a far less intrusive way.

General Comments

We believe that the existing servicing fee structure has served the market extremely well for decades and through dramatic market fluctuations. Billions of dollars of private capital have been invested in the Mortgage Servicing Rights (MSR) asset and in the software systems, physical plants, intellectual property and people required to service mortgage loans for US investors and citizen borrowers. Changing servicing compensation is no academic exercise. Changes as radical as those proposed in the FFS model will affect millions of people and dramatically alter (and likely shrink) the pool of loan servicing companies, a result that is exactly opposite that of another stated goal of the FHFA.

We are further troubled by the fact that the FHFA's working group did not include servicing practitioners, only representatives from FHFA, the GSE's, HUD and GNMA. While we acknowledge that many meetings and presentations have been conducted with industry participants, the working group developing the proposal did not include anyone beyond those mentioned above. We believe that any decisions regarding a servicing compensation change should include people experienced in the details of mortgage loan servicing who can comment on the actual cost of performing various servicing duties.

We are also confused as to how this proposal, in which Servicers would look to the GSE's (governmental agencies in conservatorship) for their compensation, aligns with the Obama administration's goal of reducing the government's role in housing. Currently, servicers get their compensation when the borrower makes his/her monthly payment. Under the proposal, servicers must rely on the GSE for payment. This would perpetuate the government's role in housing, not reduce it.

Finally, we are generally concerned about the timing of this compensation proposal in light of the ongoing attempt to establish uniform servicing standards. We believe that such standards would indeed create transparency, and would also establish reasonable expectations on the part of borrowers, investors and servicing providers. And once those expectations are established, reasonable pricing can be established. So why would the FHFA consider changing compensation without having first established the standards for which servicers are to be compensated?

Would the proposed Fee for Service Structure Accomplish FHFA's Stated Objectives?

- Improve Service for Borrowers?

It is difficult to see how paying the Servicer significantly less ($10 per month per loan for the life of the loan per the discussion paper, and no mention of fees for Non-Performing Loans –NPL's) would enhance service to Borrowers. Even today, as a mid-sized servicer servicing 115,000 loans with a relatively low average default rate of 4.5% we cannot service our portfolio for $120 per loan per year. Where would the money come from to enhance systems? Expand infrastructure? Deal with inflation? If existing incentive payments continue to kick in after 60 or 90 days, after we've proven we've completed the agency's checklist, where does the money come from to do all the things we do between day 3 (the day mandated by the Servicing Alignment Initiative (SAI) that Lenders must begin calling at risk borrowers) and day 60?

It is more likely that Servicers will be inclined to move more toward high tech/low touch servicing and less to high touch/low tech processes, or even taking the process offshore. That would dramatically reduce service to borrowers not increase it. As we understand it, FFS will be paid for by increasing the Guaranty Fee paid to the Agency. However, no mention is made of how much of an increase will be put in place or the actuarial discipline to keep adequate reserves. Further, it is likely that such decisions will be grounded in the experience of the Agencies during this most recent crisis. So it is likely that G- fees would go up dramatically thus raising rates to Borrowers.

Overall, we conclude that the FFS structure will not accomplish FHFA's goal of improving service to Borrowers.

- Reduce Financial Risk to Servicers?

On the one hand, yes, the proposed FFS structure would essentially eliminate MSR's by reducing compensation over time, but (possibly) allowing more cash flow up front. On the other hand, the servicer would be locking in a flat monthly fee per loan for up to 30 years, giving rise to inflation risk. Changes to that fee could be made unilaterally by the GSE's prospectively, further exposing the servicer to financial risk. Compounding the Servicer's counterparty risk is the fact that the GSE's are now in conservatorship and their future fate is unknown. A prudent business person would not enter into a long term contract for performance with a known insolvent counterparty.

There is no doubt that MSR's are complicated, highly volatile investments. However, properly managed and capitalized, MSR's can yield an attractive return on investment. Therefore, there is incentive for businesses to enter the marketplace when the rules of engagement have been established and are not being constantly changed.

We conclude that the FFS structure would reduce prepayment risk and hedging costs of MSR assets, but would expose the Servicer to additional, significant financial risks that are beyond the servicer's control.

- Provide Flexibility to Guarantors to better Manage non-performing loans?

We are confused as to how the proposed FFS structure would help the GSE's better manage NPL's. Eliminating the MSR asset would reduce the leverage that the guarantor has over the servicer, and likely make it more difficult to find another replacement servicer willing to take on the non-performing servicing obligation. Further, transferring servicing during a default, would hinder the GSE's ability to ensure that troubled borrowers receive appropriate loss mitigation services.

We conclude that the FFS proposal fails to make a compelling argument for improving flexibility to Guarantors.

- Promote Continued Liquidity for TBA for GSE MBS?

One of the factors in TBA liquidity is that the servicer has a certain level of "skin in the game" to help prevent the "churn" of the MBS portfolio. We believe that our investment in MSR's provides significant "skin in the game". And that investment also promotes prudent lending decisions at the origination of the loan. Knowing that we will have to earn our money from the borrowers timely payments, we are motivated to first, make loans to people who have a reasonable likelihood of repaying us and second, to do everything we can to give the borrower every opportunity to make that payment. Our MSR's are our "skin in the game". On the other hand FFS, in which we get paid by the Guarantor/Investor whether or not the borrower pays will make us less concerned about whether or not the loan we're making is appropriate for the borrower. If the industry gets paid more for non-performing loans, more non-performing loans will be made.

Other considerations

It has been argued that the impending BASEL III accord is a compelling reason for adopting a FFS Structure. We acknowledge that the limitation of servicing rights to no more than 10% of capital is an impediment to growing an MSR portfolio. However, we believe that if BASEL III is to be imposed on US banks at all (and since the US is the only member country that recognizes MSR's perhaps it shouldn't) then it should apply only as intended. That is to say Basel III should be imposed only on those internationally significant banks with assets in excess of $50 billion and not on smaller financial entities. This would have a positive result in expanding the number of servicers. As capital devoted to servicing becomes more expensive for the largest institutions, the premiums they pay for servicing rights will be reduced. Correspondents, who have historically made the decision to sell servicing because of the relatively high premiums, will see greater value in retaining servicing. Thus, without dramatic compensation structure changes, or other governmental intervention, this very simple act could not only expand the number of servicers in the marketplace, but also induce originator/servicers to make underwriting decisions based on the long term performance of the loan and not just on transactional origination cash flow.

In summary, it is our view that a FFS model would move revenue from servicers to the GSE's while disrupting the general alignment of interests that now exist among the various parties involved in the servicing of loans. FFS would increase—not reduce—the servicer's incentives to become the low cost provider by providing the minimum level of service. While that may be attractive to large, less regulated technology companies, it would harm smaller existing regional and community servicers who could not make it on $10 per loan even if they originate a high quality book of business.

Our recommendation is for the minimum servicing fee to stay at .25% at least until such time as servicing standards are enacted.

Response to Questions Posed in the 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?**
   We believe both options reduce competitiveness, service to borrowers and secondary market efficiency.

   The reserve account option really doesn't solve any problems. It simply takes a strip of the current service fee and makes the mortgage servicer earn it back again.

   The fee for service options reduce competitiveness in servicing by making the act of servicing no longer profitable. In fact one might have to book a liability. The value of servicing currently is mostly derived from the IO strip of 25 bps. Once that is monetized or removed as collateral from the servicing itself all that's left is the onerous tasks of processing payments, administering escrow accounts and dealing with delinquencies. After stripping all the real value out of the process I'm not sure our company would have a desire to do the actual servicing which would aggregate with the companies that can produce large economies of scale. The end result would be more consolidation of the servicing activities in a few large servicers. That would reduce service to borrowers as more and more loans are serviced by fewer and fewer actual servicers, just the opposite the results these proposals are trying to achieve. Since the proposal doesn't propose any changes in compensation for servicing delinquent loans from the incentive plans currently in place the service level to that borrower would likely decline or at best remain what it is today.

   Efficiency in the secondary market could be affected by increased prepayment speeds. This would be caused by the increased incentive of servicers and originators to refinance their loans as often as possible so we can monetize the IO strip as many times as possible. That is where all the money is in this proposal. This is just the opposite of the incentive today which to increase the life of the MSR asset. The increased speeds will reduce premium available in the market since MBS investors will not want to pay premiums for faster prepaying securities.

2. **What are the benefits and/or impediments to your business of having a capitalized MSR asset?**
It's an asset we like to invest in and have been since they were introduced. We feel comfortable managing their risk and can achieve an ROE that is satisfactory to our owners. It does cause a concentration on our balance sheet but one that we can manage.

a) Does the capitalized MSR impede competition in the servicing and origination market?
No. MSRs are an investment just like any other investment and those that understand them can produce a satisfactory return. In our case eliminating the MSR will reduce our incentive to produce and service loans.

b) Does the impact vary across various business and interest rate cycles?
Yes. MSRs are very volatile but so is anything else that can achieve the same returns. You have to invest your money somewhere and the best strategy is to invest in what you know. What is not assessed in the more radical proposal is the impact of a flat or inverted yield curve on mortgage banking cash flows. MSR income is an offset to reduced production income in a bear market and sustains companies in an inverted yield curve. Eliminating that buffer reduces the stability of the mortgage industry.

c) Does the impact vary across size of servicers and originators?
Probably. Servicers who have less concentration in MSRs have less impact.

d) Would greater transparency in MSR valuations improve the competitive landscape?
Greater transparency is usually a good thing but we are certain this proposal does not achieve that goal.

e) What is the impact of a potential reduction in the tax Safe Harbor?
The impact will be negative. Nothing good comes to a company from having greater tax liability. If we decide to keep a IO strip in the form of excess servicing the lack of the safe harbor obviously reduces our return.

f) Should the servicer be required to hold a capitalized MSR asset (effectively be an IO investor) as a condition of performing servicing activities?
Yes. Having that requirement creates value in the servicing asset giving it collateral value for trade and for the investor who owns the loan. It also ensures that people who perform servicing are committed to the business since they have "skin in the game". People who get into the servicing business know the MSR asset comes along with it.

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)?**
It should be attached to the MSR. Otherwise what's left is a very labor and money intensive process for which the compensation is a fraction of what it was before ($10 a month). We don't believe the leftover servicing would be of much value in the market and again would aggregate in a few large companies.

4. **Would these proposals encourage greater investment in non-performing loans operations or abilities in a benign market cycle?**
Perhaps, but in normal markets delinquent loan servicing is adequately performed by the same servicers who do the performing loan servicing.

a) How does this impact the alignment between guarantor and servicer interests?
Servicers would have an overwhelming motivation to refinance the loans as many times as possible. This would work against the interest of the holders of the guarantor's securities.

b) Would this improve service to borrowers?
We do not believe it would. It would be especially hard on borrowers if the servicing was transferred to a new servicer when the loan became severely delinquent. That would cause confusion to the borrower at a very critical time. He may be negotiating to save his house from foreclosure and suddenly find himself dealing with all new people unfamiliar with his situation. Also, the further concentration in servicing in a few large companies has already proven to not be good for customer service. The best way to deconsolidate servicing is to impose the Basel III MSR concentration limits on the very large banks and not the smaller banks.

5. **What would be the impact of the proposal on the TBA market if there were no MSR capitalization?**
Increased prepayment speeds, higher interest rates and less premium to finance closing costs.

a) To what degree might the net tangible benefit test and other suggested provisions help mitigate any potential negative impact on the TBA market?
We already do this as we suspect do most lenders. We don't believe mandating that test will make any difference.

b) What additional steps can we take to assure continued liquidity in the TBA market?
Everything in this proposal will hurt the TBA market. The best thing you can do for that market is to leave everything like it is.

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

a) Bifurcation of selling and servicing representations and warranties.
This should be expanded. This increases liquidity in the servicing market.

b) A net tangible benefit test for streamline refinances.
All refinances should have a net tangible benefit to the borrower.

c) Restriction of the amount of excess IO in a given pool.
Not necessary unless the proposal to eliminate MSRs is implemented. The existence of MSRs today has a natural effect of slowing MBS prepayment speeds.

d) Limitation of P&I advance requirements.
This would have a devastating impact on the value of the MBS's and would raise interest rates. We don't think this should be considered.

e) Flexibility for excess IO execution.
If there was more of a market for excess IO that would make servicing more liquid and more valuable and could have the effect of lowering interest rates to borrowers.

If you have any questions or require clarification, we would welcome the opportunity to discuss further.

Yours truly,

J. David Motley

David Motley

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