December 27, 2011

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

[Submitted to Servicing_Comp_Public_Comments@fhfa.gov.]

RE: Alternative Mortgage Servicing Compensation Discussion Paper

Dear Mr. DeMarco:

Thank you for the issuance of the Alternative Mortgage Servicing Compensation Discussion Paper ("Discussion Paper") and for the opportunity to provide comments on the matters raised therein. We are appreciative of the continued efforts dedicated by your organization to further stabilize and enhance the United States mortgage market, and we are grateful for the opportunity to work together in this critical capacity.

As expressed in the Discussion Paper, the topic of alternative servicing compensation structures has been in robust dialogue, with each participant noting valid concerns of current need for change and ultimate market impact. In this response, we will provide background on our firm, outline relevant analysis conducted on the Reserve Account model ("RA Model"), and articulate our preference for the RA Model along with hesitations regarding the Fee for Service model ("FFS Model") in the context of the primary goals and questions posed in the Discussion Paper.

Background

Located in Denver, Colorado, Phoenix Capital, Inc. ("Phoenix") is a mortgage banking advisor that specializes in mortgage servicing rights ("MSRs"). Since its inception in 1997, Phoenix Capital has provided consultative services to a vast array of clients, from large-cap banking institutions to small-cap regional mortgage lenders, tailoring each strategy to fit the given organization's need. With a nearly 15 year history, Phoenix Capital has provided MSR brokerage and analytical insight across various market conditions, in addition to mergers and acquisitions, asset management and surveillance guidance.

Phoenix Capital Reserve Account Model Analysis

The issues with the current servicing fee arrangements include:

- Once a loan becomes delinquent, there is no servicing fee to provide incentive to adequately service the loan; the cost to service a non-performing loan far exceeds the servicing revenues.
- The capitalized asset creates potential issues with Basel III compliance
- The servicing asset creates significant volatility for mortgage servicers, which is complicated and expensive to hedge

A reduced servicing fee could possibly be any level between 0 and 25 basis points:

- Phoenix has analyzed the economics of having a servicing fee of 5, 10, 12.5, 15, 20 and 25 basis points
- The analysis also shows the impact on large, medium and small servicers across two scenario:
  - Normal Delinquency Scenario - Uses the delinquency curve that Phoenix is applying for 2010 and 2011 Fannie Mae and Freddie Mac vintage loans
  - High Delinquency Scenario - Uses a more conservative delinquency curve that approximately reflects the performance Phoenix is seeing for Prime Fannie Mae and Freddie Mac 2007 and 2008 vintage product and excludes specialty loan programs (i.e. Alt-A, Expanded Approval, My Community, Home Possible, etc.)

Conclusions:

- The analysis supports the assumption that large servicers could service profitably with a greatly reduced servicing strip, but that is not the case for smaller servicers
- There are certainly some advantages to holders of servicing rights for the servicing fee to be lowered (e.g. capitalization rates and hedge costs would be accordingly lowered)
- The key is to ensure that the servicing fee is not lowered to such an extent that the smaller servicers are forced out of the business
- Another consideration is that the IRS will probably lower the tax safe harbor to the lower servicing fee
- Any reduction to the base servicing fee levels will ultimately lower gross margins, and likely result in increased interest rates to the borrower
- Below is an approximate servicing fee level threshold for the different sized servicers based upon our analysis:
  - Large servicers: 10 to 15 bps
  - Medium servicers: 12.5 to 17.5 bps
  - Small Servicers: 15 to 20 bps

Recommendations:

- Phoenix recommends that a reserve account be established that sets a portion of the servicing strip into a custodial account; specifically:
  - A 1-2 basis point reserve appears to be adequate with a normal delinquency curve
  - However, for the higher delinquency curve, a reserve of 3 to 5 basis points would be necessary
  - As the purpose of the reserve would be to provide adequate compensation for literally all servicing portfolios, Phoenix would recommend a reserve in the 3 to 5 basis point range
- While the custodial account will be for the benefit of the servicer as long as they are servicing the loan, a new servicer will take over the account if the servicing of non-performing loans (NPL) is transferred
- The reserve will enable there to be adequate compensation for NPL
- NPL can either remain with the current servicer or they can choose to move the NPL servicing; if servicing is moved, subservicer can be paid by servicer via ongoing and cumulative servicing fee revenue
- After some period of time, any unused reserve will be returned to the owner of the servicing rights

Specific Comments Regarding the Primary Goals of the Joint Initiative (for Reserve Account Model)

1. Improve service for borrowers:
   - Current borrowers would continue to receive existing service; non current borrowers would benefit from enhanced servicer resources due to reserve account

2. Reduce financial risk to servicers:
   - Presence of reserve account reduces servicers' exposure to heightened risk scenarios

3. Provide flexibility for guarantors to better manage non-performing loans:
   - Guarantors maintain ability to place loans with special servicer; reserve may minimize need to do so

4. Promoting continued liquidity in the To Be Announced (TBA) mortgage securities market:
   - TBA securities' liquidity would be unaffected

Phoenix Capital's 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 secondary markets?

The RA Model would have minimal effect to origination, servicing, or service to borrower aspects. It could, however, enhance the efficiency of secondary markets given the loss reserve account would exist to cover extreme conditions and permit greater confidence in the asset. Conversely, the FFS Model is thought to be detrimental as it reduces the breakeven to an "economy of scale" logic, whereby only the largest servicers can profitably sustain a servicing operation. Moreover, as competition declines, consolidation will increase, thereby negatively affecting both the market supply/demand balance and possibly the quality of servicing to borrowers.

In addition, there are various unforeseen consequences of the FFS Model which may ensue, including the shift of servicer incentive (to elevated non current loans) if additional fee revenue is received for delinquent (and other non current stages) product. Also, if all value of servicing is monetized to its effective present value, there could occur a change in the value proposition of the asset; namely, that if all value is realized upfront, the servicer incentive could be established to increase refinances so as to accelerate the receipt of the upfront present value payment(s). (Thus rendering MSR price negatively correlated to interest rates; as opposed to the present context, where MSRs are a negative duration asset.)

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

Having a capitalized MSR asset is a benefit to Phoenix given our core business is the valuation and trading of the asset. There are no impediments.

a) Does a capitalized MSR impede competition in the servicing and origination market?

No, competition is not impeded. An MSR asset can be managed, hedged and bought or sold as necessary. To the contrary, an uncapitalized FFS Model servicing asset, as stated above, would reduce competition via consolidation to the larger players who alone can profitably sustain.

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

Yes, given MSR value is a direct function of interest rates; note, though, that it also acts as a natural hedge offset in slow production cycles.

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

Yes, larger servicers are accordingly exposed to a greater extent. As mentioned above, though, such servicers can still manage, hedge or trade appropriately.

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

Transparency would generally improve the competitive landscape; given it is an illiquid market, a reliance on model inputs may still be required for robust valuation.

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

The tax liability will increase as more servicing fee becomes excess (and therefore taxed as ordinary income).

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

The owner of the asset should be required to hold it on their books as a capitalized asset. The actual entity performing the servicing activities, though, should not be unilaterally required to hold the MSR asset itself (e.g. in the case subservicers).

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)?

Having the excess IO be unencumbered by the Enterprises is of key value here. As such, our opinion is that a stand alone asset would be superior.

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

Yes, it is a function of the market's perception of the prepayment sensitivity of the underlying portfolio.

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

Yes, particularly if the Enterprises developed an MSR equivalent to the, e.g., MAJORs program, for small- and mid-size participants.

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?

We view the separation as outlined in the FFS Model as harmful to the industry - specifically, in that the capitalization of the MSR asset greatly bolsters the financial performance of a mortgage operation.

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

In a benign market cycle, we do not perceive a greater investment in NPL operations or abilities in either proposal.

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

In a benign market cycle, there would not be material impact to the alignment of guarantor and servicer interests. In a more heavily delinquent market cycle, the interests would be quickly misaligned in the FFS Model context.

b) Would this improve service to borrowers?

As discussed above, the FFS model would not improve servicer to borrowers. In fact, the service quality may decline as increased consolidation among the largest servicing entities occurs.

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

The market could witness increased prepay speeds, with the according lower security prices passed along to borrowers as higher costs / interest rates.

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

Our understanding is that various lenders are already employing similar logic. While on the surface it appears innocuous, a mandated requirement could harbor unforeseen costs. This subject would require further analysis and dialogue.

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

The TBA market is vital for a functioning housing finance system. SIFMA and other related bodies must be closely consulted and in approval of any pertinent future changes.

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

Yes, bifurcation is highly valued and enhances liquidity; it should be continued.

b) A net tangible benefit test for streamlined refinances

No, further research should be conducted.

c) Restriction of the amount of excess IO in a given pool

No, such amounts of excess IO should be left to open market participants to determine.

d) Limitation of P&I advance requirements

No. P&I advances, though potentially material, can be adequately managed. In fact, having such potentially large advances can positively incent servicers to proactively and effectively manage their book.

e) Flexibility for excess IO execution

Yes, flexibility is generally positive. As previously mentioned, an equivalent to the Fannie Mae MAJORs program for MSRs could provide needed liquidity for various market stakeholders.

Thank you again for the issuance of this Discussion Paper and for the opportunity to respond with our comments. We look forward to your feedback and further discussion.

Sincerely,

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