From: Dave Stephens [mailto:dave@ucm-inc.com]
Sent: Monday, October 31, 2011 12:04 PM
To: #Servicing Compensation
Cc: Austin Tilghman; DeMarco, Edward
Subject: Response to FHFA's "Alternative Mortgage Servicing Compensation Discussion Paper"

As requested by FHFA's Discussion Paper dated September 27, 2011, I've attached UCM, Inc.'s responses to the specific questions asked in the paper.

Best regards,

Dave

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UCM, Inc.'s Response to FHFA's Questions In Its Alternative Mortgage Servicing Compensation Discussion Paper dated September 27, 2011

The FHFA's Discussion Paper was not clear about whether the proposed fee for service ("FFS") was a life of loan contractual amount or a short-term regulatory rate that would be adjusted periodically. After first being told that the fee for service rate proposed was short-term, we've since been told that it is a life of loan, contractual amount. The rate might change periodically, but any change will be prospective for new mortgages and will not change the fee for service on mortgages already outstanding.

All of our responses below assume that the fee for service will be for the life of loan and tied to each mortgage's seller/servicer contract.

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?

If a change is required, the MBA's proposal will do a better job of matching cash flow needs of servicers to the needs and interests of consumers. Under both the current Enterprise servicing model and FHFA's proposed FFS model, there is no monthly cash flow to offset the cost of increased customer contact for the period from first delinquency to the final modification or foreclosure of the loan. The MBA's reserve proposal could make cash flows available from balances that had previously been escrowed.

The MBA's reserve proposal would almost certainly have no negative impact on secondary markets. The reserve method will actually increase servicers' "skin in the game", which would be seen as beneficial to investors and guarantors. The borrowers would be indifferent. Prepayment speeds would not be impacted versus the current servicing compensation model.

On the other hand, the FHFA's FFS proposal would move most profits from the mortgage origination/servicing cycle to the origination part of the equation. Instead of a balanced business model, mortgage bankers will be more highly incented to refinance mortgages and keep originations as high as possible. Clearly, FHFA's FFS proposal would destabilize the industry, increase prepayment speeds, reduce "skin in the game" and increase counterparty risk for the Enterprises because MSRs would lose value as collateral.

FHFA's proposal suggests that servicers retain a non-servicing Orphan IO, to make up for lost cash flows from the MSF. Unfortunately Orphan IOs will have limited marketability and sell at multiples significantly lower than MSRs. The IO would taxable and further reduce cash available from originations. The ability for non-market makers to retain any IO will be dependent on the spreads that market makers decide are appropriate in any given interest rate environment.

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

The pros and cons of the capitalized MSR asset was extensively debated in the early 1990s, prior to the issuance of the Financial Accounting Standards Board's Financial Accounting Standard #122 ("FAS 122"), which required recognition of the MSR asset as part of the securitization process. Prior to FAS 122, mortgage companies originated mortgage loans, created the MSR but didn't recognize it for accounting purposes and then sold the MSR to other mortgage companies in order to realize the value of the asset. This was very inefficient and did not serve the interests of the borrowers well at all. In fact, dissatisfaction voiced by some prominent borrowers, including some Senators, was part of the motivation for the FASB to consider the issue.

Under current accounting rules, a life of loan, FFS will result in either an asset or liability recorded when mortgages are securitized. The cash flows can be estimated whether the servicing fee is expressed in dollars per loan or basis points per loan. FHFA's proposal doesn't change the accounting only the amount of compensation. The asset (or liability) created under a FFS scheme will have the same duration and convexity risks as MSRs now have, simply varying in degree.

Since the Discussion Paper does not disclose NPL compensation, it's impossible to model the cash flows; however, we estimate that negative convexity will increase and duration will extend because the income tails will extend under a flat fee for service.

If the Enterprises magically established a fee for service that exactly equaled costs, then no asset or liability would be initially recorded at securitization. A more important question is, if the discounted servicing cash flows equaled zero, then why would anyone want to service mortgages? We believe that this is extremely unlikely, but it is remotely possible. We believe that servicers would still need to model the cash flows for financial reporting purposes to properly report impairment, should it occur.

If all the profits were taken out of servicing operation, profits would need to shift to the origination part of the mortgage banking equation, raising frontend costs to consumers in the form of increased fees, increased interest rates or both. Likely consequences include:

- FHFA's plan will drive jobs overseas at an accelerated pace. Companies like Ocwen and Zenta have already established operations in India to perform more labor intensive functions at much lower costs. When servicing compensation is reduced to an artificially low, per capita compensation, then labor costs will be a primary factor in location of operations.
- Taking profit out of the annuity part of mortgage income stream will force more of the needed profit to the front of the transaction, raising origination fees and costs for consumers.
- The CFPB will notice any increase in rates and fees and attempt to put hard caps on fees and overages, potentially squeezing bank profits to such an extent that most bankers will exit the mortgage business totally.
- Under the FFS proposal, Fannie Mae and Freddie Mac will need to manage the servicing cash flows, receiving variable income and paying fixed fees. Within three to five years they'll be projecting short falls in cash flows and unilaterally decrease the

fixed fees paid to servicers and raise the fees that they charge new borrowers for "Master Servicing" to try to balance their projections.

- There'll be absolutely no market for servicing, so those already in the business won't be able to exit. Some will abandon their portfolios and FHFA will have to hire semi-trucks to go pick up the files to transfer them to a central servicer. Millions of files will be lost.

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

FHFA has proposed no solutions that would result in no capitalized MSR. This question implies that a choice has been offered that would result in no MSR capitalization, when that is not the case.

Capitalized MSRs are tangible assets (the IRS incorrectly labels MSRs as intangible assets) that enhance the balance sheets and equity of those that manage them well. Historically, mortgage aggregators have paid originators a value that was reasonably close to fair value of the MSR, in the form of Service Release Premiums ("SRPs") added to the value paid for the mortgages sold "servicing released" to the aggregators.

When markets were disrupted in 2008, the large aggregators began reducing their SRPs paid relative to the value of the MSRs they were acquiring as part of loan purchases. Beginning in 2009 or 2010, significant originators tired of being paid a low SRP and began retaining MSRs, instead of selling all their production servicing released. This includes all sizes of originators, from those originating $20 million per month to one or two originating $1 billion per month.

For many years, the largest aggregators had disproportionately lower Guarantee Fees ("G-fees") than the smaller bank mortgage originators. For instance, at its worst, prior to 2008, Countrywide Mortgage might have had an 8-basis point G-fee on a mortgage in central Texas, where the local bank might pay 21-basis points on the same loan. This margin has narrowed since 2008, but a significant difference still exists.

The volume-based G-fees gave the largest volume aggregators a huge competitive advantage versus community banks and other small to medium sized mortgage originators. Moving to risk-based G-fees will do more to enhance competition than FHFA's proposal to confiscate servicing cash flows.

The capital markets are functioning, with new competitors moving into servicing when they sense that they've been short changed for their SRPs. The value of the MSR versus the SRP is an important factor in the decision to hold MSRs versus selling for SRPs. Another important factor is that SRPs are taxable immediately where MSRs are only taxed as earned over the life of the related mortgages.

The subservicing business has matured and is competitive enough that relatively small originators can now retain servicing without having to build a servicing platform from scratch. If the subservicing fee is 20% of the servicing cash flows, then retention of the MSR and using a subservicer is a viable option. If the subservicing fee is 80% of servicer's cash

flows, then entry into the business will stall. Because of these economics, the FFS scheme will lead to more servicing consolidation and concentration with the largest players.

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

Refinancing helps originations while prepayments hurt servicing. The value of originated servicing often subsidizes the pricing offered consumers on new mortgages, but the pricing of originations has no impact on the value of MSRs. However, a few companies chose not to hedge their MSRs and, instead, use their origination income in rallies to offset the losses in MSR value when mortgage rates drop and prepayments accelerate.

FHFA's proposal that servicers simply retain an IO if the fee for service is inadequate will only be practical in extremely low rate environments, where production volumes relative to the large aggregators' capacities are relatively high. Whenever the aggregators sense that volumes are low versus their capacities they'll lower spreads to the bare minimum. In those environments, any community bank trying to retain an "extra" 20-basis point of IO will lose 60% to 80% of their potential volume relative to the volume going to those pricing at par.

FHFA's FFS proposal strips all the value out of the servicing business, yet there will still be activity such as loan set up, loan removal, release of lien, etc. as loans go on and off the servicing system. A fee schedule will be needed to cover these activities because the proposed regular monthly fee will be inadequate.

The MBA's 20/5 reserve method servicing compensation provides more offset to MSR value decline due to prepayments because the loan-level reserve will come immediately into current income when a loan prepays. Also, when prepayments increase, forecasted cash flows will accelerate the estimated collection of the reserve fund, offsetting somewhat the decline in MSR value caused by increased prepayment. The reserve method will help fund NPLs for loans that go delinquent while also providing some prepayment relief for loans that stay current and ultimately prepay.

There will not be a separate accounting reserve under MBA's proposal, but the reserve will be reflected in the MSR valuation. If delinquencies rise, anticipated cash flows from the reserve will accelerate and reduce the decline in MSR value normally associated with an increase in delinquency. If prepayment forecasts increase, MSRs will still decline in value, but the amount of the decline will be muted by the anticipated collection of the reserve in escrow. When MSRs are sold, the reserve balances will increase the cash received by the seller.

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

FHFA's FFS proposal would make it very difficult for small originators to enter the servicing business because hiring a subservicer would become impractical. Today, the subservicer might receive 20% of the servicing fees where under the FFS proposal they might receive 80% to 100% of the cash flows.

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?

This question implies that FHFA has proposed a servicing compensation method that would lead to great transparency in MSR valuation, when that is not the case. MSR valuation under FHFA's FFS proposal would still result in an asset or liability being recorded, based on applying market assumptions to the 30-year servicing compensation cash flows. No veils of mystery will magically disappear and we'll still have an asset or liability with negative convexity and considerable prepayment risk.

With the disclosures added by FAS #156 and related fair value disclosures, MSR valuation is very transparent today. Since FAS 156's Effective Date in 2006, it has become very easy for analysts to compare the relative MSR values of mortgage bankers. There's now a full disclosure of the types of servicing held and attributes causing changes in value are now clearly differentiated between production and decay and changes in value caused by changing assumptions (primarily prepayment speed assumptions).

Under FHFA's FFS scheme the competitive advantage would go to those with the lowest cost structure, which would tend to be those with the largest platforms or the highest percentage of workforce in low cost parts of the globe. Those servicers now using subservicers cannot compete in the servicing business and would be put at the mercy of the largest aggregators for their production pricing. SRPs will go away at the FFS suggested by FHFA in this paper.

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

Corporate Federal tax rates average approximately 35%, so the reduction of the Safe Harbor servicing compensation guides, would subject any IO or excess servicing not covered by the Safe Harbor to an immediate taxation of non-cash income.

FHFA needs to understand that cash mismatches between economic income and taxable income are extremely serious issues for non-bank seller/servicers. To retain their servicing, non-banks have to very carefully plan their cash flows and take advantage of any tax cash savings that they can. If you take 25-basis points of cash flow that's tax deferred (payable as the cash comes in) and convert most of it to immediately taxable, you eliminate the hopes of most non-banks trying to enter the mortgage servicing business.

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

There are already a number of successful servicing companies that do not invest in MSRs, they're called subservicers. Subservicing as a business model has been around since at least the early 1990s.

A life-of-loan fixed fee for service will result in a capitalized MSR asset that has duration and convexity behavior that mirrors the characteristics of a servicing fee expressed in basis points. This question implies that FHFA's proposal would eliminate the capitalized asset or liability when that is simply not the case.

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)

A pool specific Orphan IO that stands alone from the MSR would have slightly more liquidity than an IO encumbered by the Enterprises and tied to the MSR. Even so, liquidity will be very low in comparison to trust IOs that have an offsetting PO. The Orphan IOs proposed by FHFA will likely trade at multiples considerably lower than MSR multiples. We already see that with valuation of Excess Servicing associated with MSRs, where that component of the cash flow receives a lower relative valuation.

Either way, the IO will be taxable in the year of creation instead of paid over the life of the loans, as the MSR is now. Paying taxes on a non-cash income item is something that all investors try to avoid.

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

The market for these Orphan IOs will likely be very illiquid, so it's hard to predict how they'll trade. Pricing is very likely to be "Type III" under the accounting rules because buyers seeking this investment will be few and far between. Traders will gravitate toward trust IOs because of the ability to offset risk with PO positions and arbitrage between the IO and PO. The proposed Orphan IO offers no correlated arbitrage.

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

The market for these orphan IOs will likely be very illiquid, so it's hard to predict if or how they'll trade. Pricing is very likely to be "Type III" under the accounting rules because buyers seeking this investment will be few and far between. Traders will gravitate toward trust IOs because of the ability to offset risk with PO positions and arbitrage between the IO and PO. The proposed orphan IO offers no correlated arbitrage.

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?

If the FFS proposal is life of loan, then there will be no difference between accounting for a fixed-dollar based fee and a fee expressed in basis points. The accounting for MSRs is crystal clear, requiring initial capitalization of either an asset or liability when the mortgage is sold and the servicing right is retained, based on fair value. Fair value is determined by discounting the projected market cash flows at a market rate.

Today, if a mortgage servicer wants to stay in the servicing business and have no MSR investment, they become subservicers.

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

This question cannot be answered until FHFA finally unveils its proposed NPL compensation scheme. The proposal on the table doesn't even cover the cost of performing loans. Effective October 1, 2011, Fannie Mae began requiring servicers to contact borrowers that are only three-days of delinquent. This requirement and other new requirements, such as answering the phone within 60-seconds, etc. will require greater investment in non-performing loan operations, whether the servicer is fairly compensated or not.

FHFA's FFS will drive some servicers out of the business. New entrants will be much less likely under FHFA's FFS proposal. Since FHFA's proposal does nothing to fill the cash flow gap between first delinquency and either modification or foreclosure, it's hard to imagine more investment in NPL operations, other than the minimum required by the new servicing standards, which haven't been fully developed.

On the other hand, the MBA's reserve method could provide cash flows during the gap between first delinquency and either modification or foreclosure. This proposal deals with the business problem of funding operations during the months that a loan can be in the gap. Today, the servicer must bear the direct operating costs, advance principal and interest in certain instances and potentially repurchase loan under the representations and warranties as a seller/servicer.

The MBA's proposal would not totally offset the burdens of servicing delinquent loans, but it would partially defray some of the cash flow burden. The incentive to bring the loan current or successfully modify the loan will remain strong because that's the only way the servicer can collect the delinquent servicing fees. The servicer does not collect the delinquent servicing fees in a GSE foreclosure.

The MBA's proposal partially defrays servicing costs while maintaining a strong incentive to either bring the loan current or modify it.

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 in the event of a servicer failure. Over the lives of the Enterprises there have been many instances where the only thing of value at a failed institution was the MSRs, which could be seized by the Enterprises and sold at fair market value.

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 Enterprises' counterparty risk.

b) Would this improve service to borrowers?

No. It's hard to imagine a scenario where reducing the profits of a business will improve the quality of service to borrowers. Generally, in either a capitalist or Marxist economy,

decreasing compensation reduces quality of service. History is full of economic "planners" implementing flawed economic plans that either reduced quality of service or brought enterprise to a total standstill. FHFA's scheme has many of the hallmarks of such unfortunate planning.

National servicing standards are the best way to improve service to borrowers. Reducing servicing compensation and expecting it to increase service to borrowers defies logical economic analysis. There is absolutely nothing in FHFA's FFS proposal that will increase service to borrowers.

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

Mortgage Securities investors will like the MBA's 20/5 reserve proposal because it increases "skin in the game" by servicers. If a servicer is failing, then the servicing can be moved more easily because of the cash reserves held in escrow.

This question implies that a proposal has been made that would result in no MSR capitalization. Once again, 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.

If magically there were no MSR at all, then all the profits of mortgage banking would move to the origination side of the business. This would greatly increase the cyclical nature of the business and its dependency on refinance originations. This would surely increase the propensity for prepayments, but it's difficult to predict how much. Uncertainty is bad for the TBA market and is will certainly be reflected in bond prices and yields.

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

Borrowers have long established their own tangible benefit test when considering refinancing. The interest savings needed to be enough to justify the up-front cost or 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.

When refinancing volume is needed because production capacity outstrips production volume, then aggressive lenders will aggressively market refinances to all those that qualify. The tangible net benefits test simply puts all in-the-money borrowers on the same footing.

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

Adopt the MBA's 20/5 reserve proposal. This will further protects investors and guarantors by making cash flow available to fund servicing operations during the gap between first delinquency and either modification or foreclosure.

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

This issue should be considered separately from servicing compensation. It has more to do with the appropriate responsibilities of the parties. Saddling the servicer with the seller's representations and warranties limits the ability to transfer servicing. When the selling servicer is healthy, very substantial hold back reserves are established and tie up millions of dollars for years. If the selling servicer is not healthy, then any buyer is very reluctant to assume the servicing obligation without relief from the Enterprises or FDIC. This raises the question, if some are granted relief then why not all?

b) A net tangible benefit test for streamlined refinances

This issue really doesn't belong in a servicing compensation discussion. Yes, it's an important issue, but it's entirely separate from servicing compensation.

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

The markets will impose a practical limit on the amount of the excess IO in a given pool. At times it will be close to zero and other times (when production capacity is short and rates are low) it might be 15 to 30-basis points. The thin market for Orphan IOs will keep the size of IO relatively low.

d) Limitation of P&I advance requirements

Sellers have long had the option to sell mortgages to the Cash Window and receive an Actual/Actual remittance pattern, where no delinquent P&I is advanced. In recent times many sellers, particularly non-banks, have elected this type of remittance because low short-term interest rates have limited the earnings power of escrow accounts so that there is little to offset the obligations to advance.

Broadening the availability of the Actual/Actual remittance type is worth considering because it makes it easier for non-banks to compete with banks.

e) Flexibility for excess IO execution

What is excess IO?

Flexibility for excess IO execution should be as great as possible. The market for the orphan IO is likely to be very thin, so the more flexibility in style of ownership the better. Market makers will still set the pricing and determine the IO that's available in each market environment. A substantial MSF, such as the MBA's 20/5 reserve proposal, removes this uncertainty for the servicer and protects the tax advantage of the MSR versus IOs and excess servicing.