From: Peace, Rebecca [mailto:rpeace@phfa.org]
Sent: Monday, November 14, 2011 7:31 AM
To: #Servicing Compensation
Cc: Newton, Kate
Subject: comments to joint initiative proposal

Thank you for the opportunity to comment on the proposal.

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Federal Housing Finance Agency
Washington, DC 20551

Re: Comments on the Alternative Mortgage Servicing Compensation Discussion Paper

Following are comments on the two proposals put forth as a result of the Joint Initiative to consider alternatives for a new mortgage servicing compensation structure.

By way of background, the Pennsylvania Housing Finance Agency ("PHFA") is a state agency, created and existing pursuant to state law in the Commonwealth of Pennsylvania. Like other state housing finance agencies, we are a mission-driven, state chartered entity whose purpose is to provide affordable housing. We are a frequent issuer of tax exempt and taxable bonds to finance residential mortgage loans. Our program has been in existence since 1982 and we have funded more than 145,000 affordable fixed rate mortgage loans for low and moderate income Pennsylvania households. The consumer mortgages financed by PHFA are originated by private banks and mortgage lenders and then acquired by PHFA with the proceeds of the financing. PHFA dictates the underwriting guidelines for the loans it funds, and we have always required full documentation. We also perform our own independent review of the originating lender's loan file both before closing and also prior to our funding of the closed loan. PHFA also offers closing cost and down-payment assistance in the form of no-interest subordinate loans, assistance for making homes accessible for persons with disabilities, and homebuyer education at no cost to the consumer.

All of the loans are serviced by us for the life of the loan. Importantly, we service these loans in-house, and we boast a default rate that is consistently lower than both state and federal numbers. Long before the "bubble" and the recent crash, we developed and implemented principal reduction plans, loan deferments and interest rate reductions to keep households in their homes during fluctuating economic times. Because we are mission-driven, we have always felt that this is consistent with prudent lending standards. Since we originate intending to service directly for the full life of the loan, we have an additional incentive to utilize sound underwriting guidelines with thorough documentation. As part of our quality control process, we also routinely monitor the performance of our loans for trends and patterns relating to delinquencies, adapt our underwriting guidelines accordingly and conduct additional lender training, when appropriate.

Our staff is directly and actively involved in the servicing, which goes far beyond simply processing payments and handling escrow accounts; it includes budgeting, as well as debt and delinquency counseling. In addition to our in-house servicing staff, we have robust counseling and support programs for our consumers so they can obtain in-person, intensive counseling (through a network of independent counseling agencies.) We are responsive to the needs of our constituents; we know what, when and how local communities are affected by disasters; we study and respond to shifting economic and employment trends; and we understand local economies and regional markets.

Consumer loan servicing is a fundamental part of our core mission and business. Increasingly, other state housing finance agencies are entering into the servicing sector as well. It is the mission of housing finance agencies across the nation to provide affordable, sustainable financing to low and moderate income populations and to address specific affordable housing needs indentified at the state level. This mission fulfills a vital component of a robust housing market and healthy economy.

We are presenting comments with regard to the general goals of the Joint Initiative and to some of the specific conclusions set forth in the proposals. At the onset, we note that the general goals stated are laudatory: to improve service for borrowers, reduce financial risk to servicers, provide flexibility for guarantors to better manage non-performing loans, and promote continued liquidity in the TBA mortgage securities market.

A further stated goal is to consider whether changes in servicing compensation could lead to enhanced competition in the market for originations and servicing. We are cautious about whether these changes in compensation structure will lead to enhanced competition. There has been a consolidation in the number of servicers in the market, which is impacting all sectors of the housing market (not just the TBA market.) State HFAs are increasingly finding that there are very few entities which have the capacity or the desire to service their loans. Consumer loan servicing is increasingly fraught with regulatory peril, as Dodd-Frank imposes new credit risk retention standards which may impose losses on investors for problems in the upfront origination long into the life of the loan. And the technology required for servicing is growing in complexity, with additional state and local requirements. Judicially crafted mitigation and foreclosure diversion programs are affecting expectations and timeframes, as well as increasing legal costs of compliance with all processes and protocols. Additional reporting demands and the cry for "greater transparency" also add to the disincentives. It is not surprising to us that there is a shrinking number of private entities engaging in the servicing business these days. The risk and reward of servicing programs is definitely in a state of flux.

As a general matter, we note a troubling sentiment expressed in the presented proposal which suggests that the secondary market is somehow part of the woes of the recent housing crisis. We beg to differ. The secondary market has in fact worked, and it has continued to work, even while other markets failed and even though the word "housing" has triggered pause in many investor communities. There are several conclusory statements in the proposal which are not explained or supported. (For example, ..."The uniform mortgage data program will reduce R&W exposure by improving the consistency;" and "...the incentives inherent in the current servicing compensation model contributed to these [sub-standard servicing] problems.") These statements seem devoid of empirical support and we urge you to exercise caution as you explore meaningful ways to enhance market performance.

In response to the specific questions outlined in the Proposal:

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 market?

The first set of suggestions in the paper are relevant to for-profit servicing entities as they directly address specific capital reserve, accounting, and tax issues which affect these entities. As a mission-driven state entity, we are not motivated by these factors and we would not support a proposal which adopts a "solution" to a "problem" we do not have. Responding to Basel III by adopting preemptive industry standards is dangerous, as we do not have any idea what the market will actually be and we think some of the proclaimed standards will ultimately be relaxed. In fact, such a solution imposed on our practices may be punitive and may adversely impact our ability to continue to service loans in an efficient and responsive way designed to address the continuing needs of our consumers. Any required posting of funds into a targeted reserve would not serve our lending programs well and would require us to deploy real dollars away from other mission driven lending activities. (The dollars held in a reserve would not be available for down payment assistance or closing cost programs which are fundamental to the first time and lower income homebuyer markets.) As noted above, we service our loans for the life, and while an investor may require that we pledge certain amounts to allow them to hedge against performance issues, we think this should remain a contractual negotiation point between investors and servicers.

It is troublesome that Fannie Mae may be able to dictate pricing (as proposed in the second tier of the second alternative.) Pricing should truly be transparent, as is the case with the Ginnie Mae MBS model, so that there is no ability for larger volume businesses to manipulate or to "corner" the market. We have found sometimes that the affordable industry is inadvertently penalized in pricing models because of a false perception that our low and moderate income loan portfolio is somehow "riskier" than the conventional jumbos and "regular" consumer market, and because we have chosen to focus on quality rather than quantity. In fact our experience and statistics during the most recent "crash" debunk this false perception, as <u>our delinquency and default rates are consistently below federal and state loan counterparts</u>.

#2. We do not think a mission-driven entity like an HFA would have any need or desire for a capitalized MSR asset. Having funds reserved means they are not available for other lending or mission related purposes.

It would be more advantageous for larger servicers and would artificially favor them in the market, since the capitalization process seems to be addressing their need for Basel III and tax, accounting relief. We do not have those concerns and would not support a system that creates a *de facto* different pricing model due to the existence of a new asset that would be available for creditors.

b. Also, depending on how pricing is "manipulated" there may be greater or lesser incentives for larger or smaller size loans. Our program is generally smaller affordable loans ($120,000 average), and we encourage you to take great care to ensure that our ability to make and service these loans is not impeded by a change in the real pricing models to favor larger loans.

c. We are a modest sized servicing shop, faced with technology demands and increased reporting and ever enhanced servicing standards. We urge you to consider how the imposition of additional standards will affect the smaller shops, as the model already heavily favors large servicing entities.

d. Transparency in MSR valuation does not appear to have been an issue in the competitive market. Accurate valuations are unique to each servicer and can be influenced not only by volume and performance, but also by microeconomic factors and conditions (e.g. the regional/state economy, the financial 'culture' - i.e., how comfortable the population in a given area is to riskier financial products such as ARM's; whether the population tends to be transient or younger, hence increasing prepayment speeds; the condition of the housing stock, etc.) A uniform, cookie-cutter approach may not yield the most accurate results.

e. We are not motivated or affected by the tax Safe Harbor and we do not think the proposal should favor a model because of tax treatment one way or the other- the proposal should be kept neutral.

f. No, this requirement to hold a capitalized MSR asset should not be imposed. It should be a fundamental negotiation point between investors and servicers to secure performance. Why would you want to require servicers to hold MSF asset to perform a service? This may also essentially eliminate the role of sub-servicers.

3. Should the excess IO remain contractually attached to the MSR or would you want to have the excess IO be separate (unencumbered by the enterprises?) We support a system that will establish consistency and fairness between the "buy up" and the "buy down" requirements imposed by the GSE's in the market.

a. Does the impact from market based pricing of the excess IO vary?

It would be a realistic assumption that higher volume players would stand to be advantaged, hence discouraging smaller investors/servicers from participating in the market. If this is a possible outcome, given the already small number of servicers in the current market and given the trend to retrenchment, we encourage you to be extremely cautious about this approach.

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

Although it sounds like it would, we fear that it may instead discourage smaller players from entering the market. Liquidity has not been a problem, so this will not really address any problem in the market. Because the larger players will negotiate on pricing, this may, in fact, result in less pricing transparency as the note rate calculations will be heavily negotiated by volume players.

c. Is the flexibility to separate the operational activities (servicing) from the financial management activities beneficial or harmful? We do not care about the financial management aspect of this as much as a for-profit Basel III regulated entity may. We should not have to "pay" for this flexibility.

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

One proposal that should really improve the market is the bifurcation of liabilities associated with origination. The successor servicer has a real disincentive if they have to absorb origination risk of the portfolio that they are assuming, especially given that they are likely picking up the portfolio after a time of stress or nonperformance. This is not an issue generally for a state HFA like Pennsylvania, except if we begin to offer loan servicing to other nonprofits or mission-driven entities. We would like to be able to limit our exposure to the origination representations and warranties, as we had no role in these matters and no real ability to assess the attributes of the loans at the time we absorb servicing.

a. Guarantors should recognize that successor servicing may cost more. The model should accommodate that.

b. Consumers would be best serviced in our experience by an entity which has reason, beyond profit, to be responsive to their needs and which is vested with a responsibility to respond to the shifts and the vagaries of the market. This is the HFA model. It may reflect some intrinsic tension with the for-profit big bank servicing model.

5. Impact on the TBA market if there were no MSR capitalization?

We are unclear about the overall impact of this idea as each servicer has different accounting constraints.

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

Since the TBA market is liquid and efficient, we urge you not to tinker with it.

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

Recognize that the model works and do not fix what is not broken. We also encourage the current buying by the Federal Reserve.

6. Should any of the following provisions be considered separately?

a. bifurcation of selling and servicing representations and warranties- Yes.

b. a net tangible benefit test for streamlined refinances? Yes. This is consistent with the spirit of Dodd-Frank which provides an exception to certain "ability to repay" underwriting requirements for certain streamlined refinances which demonstrate a benefit to the consumer.

c. Restriction of the amount of excess IO in a given pool? (What does this achieve? Why not let the market dictate what things are worth between investors and servicers?) This could interfere with a prudent servicer who has chosen a pricing structure with more excess IO to compensate for assumed additional risk due to either the loan product characteristics or economic conditions and could add additional cost to servicing.

d. Limitation of P&I advance requirements? Yes, especially given some of the loss mitigation requirements and delays now being experienced across various state and local markets.

e. Flexibility on excess IO execution- Yes, we suggest that this would be positive, as it would allow weaker entities to "pay up" and would allow good performance to be compensated.

We suggest looking at Ginnie Mae's model which provides two alternatives- Ginnie Mae I MBS or Ginnie Mae II MBS. The first have flat MSF of 44 bps and the securities trade on the half and whole coupon rates (44 MSF plus 6 bps guarantee fee), while the second class has an MSF between 19 and 69 thereby resulting in excess IO or the opposite (a servicing fee below the standard 44 bps MSF). Because there are no "buy-ups" or "buy-downs" in Ginnie Mae's model, the excess or sub-MSF is accounted for by the servicer/investor using its own valuation based on its performance history and cost to service.

At the same time, we encourage you to maintain the flexibility in the existing Fannie Mae/Freddie Mac cash windows. Any changes made within the servicing compensation model should be carefully balanced to ensure that existing financing and delivery systems that work remain unhampered. We are ever wary of how well-intended regulatory structures may have unintended consequences that affect markets.

We appreciate the opportunity to provide our feedback to you as you develop your criteria during this fragile time in the housing market. We encourage you to allow for flexibility in the application of these standards to the extent necessary to support a robust recovery of affordable housing market and responsible lending. To this end, we suggest that you appreciate the unique role of state housing finance agencies in filling gaps in the housing delivery system for people of modest means and with special needs. Our second mortgage loan and grant programs, employer-assisted housing programs, and initiatives to address special issues in our markets allow us to achieve our mission. To the extent it is possible for you to reflect upon this aspect of the market as you develop these standards, we urge you to consider doing so.

Thank you very much for affording us an opportunity to provide our comments on the joint initiative. Please feel free to contact either of us (as set forth below) if you have any questions regarding any aspect of our suggestions or discussion.

Very truly yours;

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