Via Electronic Delivery

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

Dear Mr. Demarco:

On behalf of the undersigned, attached please find our comments on the two alternative mortgage servicing compensation structures detailed in a discussion paper dated September 27, 2011. We would like to thank you for your efforts regarding potential changes to loan servicing compensation. With your guidance, the Mortgage Finance Industry has within its grasp the opportunity to improve the manner in which participants value and manage loan servicing. With your leadership, we will have a more stable and reliable mortgage marketplace for servicers, originators, investors and, importantly, consumers.

Lenders One has taken an active role in analyzing this issue. Lenders One is the nation's largest mortgage cooperative. With over 200 Members that operate in all fifty states and an annual origination volume that exceeds $100 Billion, the 17,500 employees of the Members of Lenders One have a vested interest in the outcome of this discussion. Perhaps more importantly, the consumers that we serve in our communities do as well

Lenders One formed a members Servicing Compensation Committee to analyze this complex issue. The Lenders One Servicing Compensation Committee voted unanimously in support of Option B modified to include a reserve account. In addition, to date, over 50 Lenders One Members have given us permission to use their name in support of our response.

For the many reasons detailed in our comment letter, we urge adoption of the 'Fee for Service' compensation structure coupled with a 3 to 5 bps reserve account. It is noteworthy that the proposals made by the MBA and The Clearinghouse amongst others are actually a subset of the solution offered in combining the Fee for Service proposal with a modest reserve account. As the FHFA's Fee for Service proposal allows for the retention of the excess IO, the originator under this proposal can effectively achieve the same position as advocated by the MBA and The Clearinghouse. We believe that the Fee for Service proposal will facilitate a vibrant, healthy lending and servicing market based upon quality and efficiency.

We look forward to working closely with you and the industry to develop a new standard that serves us all well for many years to come.

Sincerely,

Lenders One

The Lenders One Servicing Compensation Committee

Ian MacGillivray – Los Alamos National Bank
Paul Peterson – First Interstate Bank
Todd Hempstead- CMG Mortgage
David Griege – Paramount Mortgage
Jim Carroll – The Carroll Mortgage Group

Affiliated Bank

American Financial Network, Inc.

American Mortgage and Equity Consultants, Inc.

American Mortgage Service Company

Apex Home Loans, Inc.

Aurora Financial Group, Inc.

Bank of Idaho

Centennial Lending Group, LLC

Century Mortgage Company

Chicago Bancorp

Churchill Mortgage Corporation

CNN Mortgage

Directors Financial Group

Draper and Kramer Mortgage Corp.

Extraco Mortgage

First Centennial Mortgage Corp.

First Equity Mortgage Bankers, Inc.

Gershman Mortgage

GSF Mortgage Corporation

Guardian Mortgage Company, Inc.

Hallmark Home Mortgage

Hancock Mortgage Partners, LLC

Highlands Residential Mortgage

Home Owners Mortgage Express

Homewise, Inc.

Howard Hanna Mortgage Services

Legacy Mortgage, LLC

Legacy Mutual Mortgage

Market Mortgage

Mortgages Unlimited, Inc.

NJ Lenders

North American Savings Bank, FSB

Pinnacle Mortgage Group, Inc.

Proficio Mortgage Ventures

Residential Finance Corporation

Residential Home Funding Corporation

Ruoff Mortgage Company

Sidus Financial

South Pacific Financial Corporation

Sun American Mortgage Co.

Sunstreet Mortgage, LLC

The First Mortgage Corporation

Unifirst Mortgage Corporation

Veterans United Home Loans

Victorian Finance LLC

Watson Mortgage

Weststar Mortgage, Inc.

FHFA Alternative Mortgage Servicing Compensation Discussion Paper, dated September 27, 2011

Introduction
FHFA has invited comments on two alternatives proposed in its discussion paper. Option 1 would reduce the servicing fee modestly, create a reserve account to meet the increase in cost of servicing non-performing loans and still result in a significant MSR capitalization. Option 2 would replace the current compensation structure with a 'Fee for Service' structure while still allowing originators and issuers to retain the excess IO strip if they wish to do so.

For the many reasons explained below, we urge adoption of a hybrid of both options. In particular, we recommend modifying Option 2, Fee for Service, to include a 3 to 5 bps reserve account to meet the increase in cost of servicing non performing loans and clearly allowing a lender to retain additional excess servicing based on their view of costs and risks to service loans. This option will facilitate a vibrant, healthy lending and servicing market based upon quality and efficiency.

Our responses to the specific questions raised in the FHFA's discussion paper are set out as follows.

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?**

   Current Scenario: Any analysis of the competitive impact of the servicing fee proposals must begin with a discussion of the dynamics around the costs of owning and servicing mortgage servicing rights ("MSRs"), which costs are comprised of two components: the cost of capital and the cost of servicing. The cost of servicing, in turn, is comprised of the cost of servicing performing loans and the cost of servicing non-performing loans.

   As the FHFA correctly points out, the operating cost for efficiently run servicers to service performing loans is 3 bps. Even the less efficient servicers can profitably service performing loans at 5 bps. Leaving aside for the moment the cost of servicing non-performing loans (which we will address below), the difference between the cost of servicing performing loans and the current 25 bps Enterprise servicing fee ranges from 20 to 22 bps. This differential represents the excess spread, the equivalent of an interest only ("IO") strip, wholly unrelated to the cost of servicing the loan. In the overall economics of MSRs, the cost of capital is therefore four to seven times more important than the cost of servicing performing loans.

   For the MSR owner/servicer, then, even a small competitive advantage in the cost of capital far outweighs any servicing operating efficiencies. The cost of capital for commercial banks is low due to easy availability of low cost, government insured deposits. As against non-depositary servicers that do not have the benefit of low cost deposits leveraged at 12 to 15:1, the commercial banks' capital cost advantage is approximately six times greater. Further, the excess fees result in the capitalization of a MSR asset that requires complex hedging to effectively manage. The smaller firms that don't have the availability of capital at a competitive cost or have the capital markets expertise to efficiently hedge MSRs are therefore forced to sell their MSRs to the larger depository institutions.

As a result, the market for MSRs is now dominated by five large institutions. All other players, even those who have developed superior efficiencies in the cost of servicing, are nevertheless placed at an insurmountable competitive disadvantage.

The FHFA's thought leadership on mortgage servicing is timely. The mortgage industry is at a tipping point. As concentrated as the servicing and lending industry already is today, absent reform in servicing fees, it could easily become even more concentrated with the recent exit of Bank of America, Ally Bank and MetLife from the business of purchasing loans and MSRs from independent mortgage bankers. As a result, the mortgage banker's ability to survive in the long-term is questionable. With the lack of meaningful competition to originate and acquire loans, it is not unrealistic to expect that margins in mortgage origination will expand driving mortgage rates higher for consumers with all of the attendant issues.

Against this backdrop, we believe reforming servicing compensation along the lines of that presented in Option 2, Fee for Service, coupled with a 3 to 5 bps reserve account for servicing non-performing loans and allowing a seller/servicer to choose how much servicing to retain, is the preferred policy option. This would encourage much needed origination and servicing competition; competition based upon quality and efficiency, not cost of capital and hedging advantages. Further, servicers would be motivated to provide effective and efficient service in-line with established servicing standards in order to retain the servicing fee stream. This competition will reduce mortgage rates to consumers, improve origination and servicing quality to borrowers and reduce loan servicers' financial risks associated with holding MSRs. The reserve account can be either used by Enterprises to cover the cost of non-performing loan servicing or it can be released if pre-determined pool performance standards are met by the servicer.

While Option 1's modest reduction of servicing fees to somewhere between 12 and 20 bps might appear to be attractive on the surface, it does not address the critical problem of concentration in the mortgage industry. In fact, Option 1 could only exacerbate the problem. Basel III is a threat to limit the servicing portfolios of the five large depository institutions by restricting MSRs to 10% of capital. Option 1 would reduce servicing fees from 25 bps to 12 bps, which likewise reduces the value of MSRs. This would therefore permit the large depository institutions to continue their servicing expansion within the constraints of Basel III, while simultaneously maintaining a capital cost barrier sufficient to preclude meaningful non-depository servicing competition.

It is noteworthy that Option 1, as set forth in the proposals made by the MBA and The Clearinghouse amongst others, is actually a subset of the solution offered in combining Option

2 with a reserve account. As the FHFA's 'Fee for Service' proposal allows for the **retention of** the excess IO, the originator under Option 2 can effectively achieve the same economic position as advocated by the MBA. At the same time, Option 2 provides originators that are not large depositories an opportunity to meaningfully participate in the origination and servicing business by providing a servicing fee option that eliminates the capital cost barrier. Option 1 essentially limits the flexibility on the minimum servicing fee offered by Option 2 with the primary outcome of maintaining the capital cost barrier that reduces non-depository origination and servicing competition.

There have been three primary concerns raised by certain market participants against Option 2. Our responses to these concerns are outlined below:

a) Expected higher refinancing activity associated with a lower 'Fee for Service':

Proponents of Option 1 argue that without a capitalized MSR asset (and thus nothing to impair), there would be a profit incentive for the current servicer / lender to refinance loans and therefore there will be higher prepayments. This argument miscomprehends the salutary impact that Option 2 would have in actually *lowering* refinancing activity.

The correspondent channel has higher refinance rates than the retail channel.

Option 2 will afford all originators the opportunity to deliver their loans directly to the Enterprises, i.e., retail channel, as opposed to Option 1 which will maintain the current structure whereby mortgage bankers are required to deliver their production to the large depositories, i.e., correspondent channel, due to the capital intensity of the MSRs

It is understandable as to why the correspondent channel has higher refinance rates as there are two parties in the correspondent channel motivated to refinance the loan – the mortgage banker and the correspondent. On the other hand, in the retail channel there is only one party motivated to refinance the loan. Under Option 1 or Option 2, the mortgage bankers' incentive to refinance is identical since in neither case does the mortgage banker typically hold the MSR.

Option 2 will result in a greater percentage of retail originations where only one party (the mortgage banker) has an incentive to refinance the borrower. Option 2 will therefore lead to lower prepayments and, with it, increased homogeneity and prepayment activity associated more with borrower awareness (i.e., interest rates) than with fluctuations in channel composition.

It is ironic that the capitalized MSR is actually the cause of higher refinance rates. Correspondent lenders have a significant economic interest in preserving not only the MSR but also the overall banking relationship with the borrowers generating substantial additional retail banking fees, i.e., cross selling other products. Indeed, the large correspondent lenders have substantial resources invested in call center operations and use analytics, letter programs and other means to rapidly refinance borrowers on loans where MSRs are deemed at risk.

And finally, the argument fails to recognize the efficacy of the FHFA's proposal to implement a net tangible benefit test for streamlined refinance programs along with enhanced monitoring and tracking of prepayment speeds. We believe these initiatives are more than adequate to mitigate the risk of higher refinancing activity.

b) ***Proposed 'Fee for Service' is not adequate compensation for small servicers and favors larger servicers:***

MSRs are less valuable for a high-cost servicer than a low-cost servicer. Under our proposal, small originators / servicers will have the option to either outsource servicing to an efficient servicer or retain an excess IO strip to cover the higher expenses of in-house servicing. Option 2 does not alter the relative competitive position of smaller servicers against larger and/or more efficient servicers in any way.

c) ***Servicer has no incentive to adhere to adequate servicing standards in the absence of a risk of a MSR seizure:***

We are not aware of any empirical evidence suggesting a positive correlation between investment in MSRs and the quality of servicing. In fact, just the opposite may be the case as high touch, special servicers are often regarded as the highest quality servicers, and they generally don't own MSRs.

We acknowledge that the threat to pull servicing without compensation could be a powerful inducement. Nevertheless, it does not appear to be a threat that has ever been carried out. In almost all instances that we are aware of, the Enterprises have paid the incumbent servicer before transferring servicing to a new servicer. Therefore, the current structure does not provide an effective deterrence against poor servicing quality and actually burdens the Enterprises with an additional cost of servicing transfer. Under Option 2, Servicers still must adhere to servicing performance standards in order to retain seller-servicer status for future loan sales to agencies. In addition, our proposed construct of a 3-5 bps reserve account that can be recaptured by the originator based on loan performance provides further incentive to maintain adequate servicing standards and reduce loan defaults. Further, despite these incentives, if the servicer fails to maintain adequate servicing performance, the Enterprises can transfer the servicing to a new servicer and use the reserve account to pay the new servicer for the higher cost of servicing non-performing loans.

In summary, any compensation structure that results in a sizeable MSR capitalization will only increase the level of servicing concentration that exists today, impede lending competition and ultimately negatively affect consumer mortgage rates and service quality. FHFA's "Fee for Service" proposal with a 3 to 5 basis points reserve account as suggested in our response promotes the interests of all stakeholders.

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

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

Yes, a capitalized MSR impedes competition in the servicing and origination market.

First, by definition a MSR is capital intensive and, therefore, discriminates between market participants that have ready access to low cost deposits and those that don't.

Second, even if small originators could afford to retain servicing, the complex hedging requirements and valuation volatility associated with managing MSRs act as a barrier to entry.

As a result of these issues and the need for the small originators to generate cash to run their operations, most originators must sell their loans servicing released. With two of these banks exiting the correspondent market, small originators are forced to sell their loan originations servicing released to the two remaining large correspondents. With fewer correspondents in the business, and access to low cost capital being the primary constraint to additional competition, mortgage bankers' margins are being squeezed making it very difficult to remain in business. This elimination of competition for the consumer home loan business will ultimately increase the cost of borrowing to consumers.

The FHFA's servicing fee proposal allows originators to retain servicing and sell their loans directly to FNMA, FHLMC or GNMA. Originators that are not qualified to service, don't want to service or cannot profitably service their loan originations, can outsource the servicing to a qualified third party without impacting their economics. Further, under Option 2, less efficient servicers have the option to retain an excess IO strip to cover their higher expenses of in-house servicing. These dynamics allow for a vibrant, healthy lending and servicing market based upon quality and efficiency, as opposed to a limited origination and servicing market controlled primarily by those that have access to low cost capital and capital markets expertise.

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

Yes. Due to the inherent nature of an IO, MSRs contribute to earnings volatility during interest rate cycles. A drop in interest rates typically triggers loan refinances and increases prepayment speed. Under the current servicing fee construct, this increases MSR amortization costs, adversely affecting earnings. Originators rely on complex hedging and natural hedges provided by their production volume to manage this earnings volatility. Historically, hedging MSRs with a high degree of certainty has not been an easy task. The gains on hedges are often not adequate to cover the losses due to declines in MSR value. Origination capacity is not perfectly elastic, especially in the short-term resulting in the reduced effectiveness of a natural hedge. While the inter-play between servicing, origination and business/interest rate cycles is a given phenomenon, the capitalization of MSRs makes servicers' earnings more volatile and sensitive than necessary.

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

Yes. The large depositories have the expertise and can afford to use complex derivatives and financial instruments to hedge the value of MSRs, mitigating earnings volatility to an extent. Such an option is a difficult and expensive proposition for small players with limited capital markets expertise.

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

There is a wide dispersion observed in the values assigned to MSR assets across Servicers. Greater transparency in MSR valuation will promote safety and soundness of financial markets and will help in avoiding significant impairment to MSR asset valuations. While greater transparency will help in enhancing the safety of the financial markets, its impact on reducing servicer concentration would be limited. A MSR is still an asset that has to be capitalized and managed on an ongoing basis. All the issues that impact competition in today's servicing and origination market will continue to prevail.

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

The absence of a MSR will provide greater certainty in the tax treatment of revenue and expenses associated with servicing compensation and allow for greater congruence between revenue, cash flow and income taxation.

Under the Safe Harbor provisions, servicers amortize MSRs over 9 years if held as an asset or 15 years if the MSRs are acquired along with a trade or business. This amortization methodology, given current prepay speeds, creates a mismatch between cash flow, accounting earnings and tax earnings generating a Deferred Tax Asset which is difficult for non-depository institutions to finance. If the servicer compensation model is modified to a

‘Fee for Service’ structure that does not give rise to an MSR asset, the originator has the option to either retain the excess IO strip or sell it. In the event of a sale, cash proceeds are more than adequate to meet tax liabilities. If an IO strip is retained, the revenue from the IO will be recognized for GAAP on a fixed income basis, which should mirror both cash flow and the revenue recognition method allowed for tax purposes.

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

No. A servicer should not be required to hold a capitalized MSR asset as a condition of performing servicing activities. For large and small players alike, the capitalized MSR does not benefit borrowers or investors. The capitalized MSR serves to reduce competition for loans and servicing.

A servicer that is paid a competitive fee to service its loan has every incentive to meet established servicing standards and retain the servicing. Servicers should be evaluated based upon their effectiveness in performing their core servicing activities pursuant to established servicing standards. For those servicers that don’t meet established servicing standards, the investor or guarantor should retain the right to transfer the servicing, without compensation and with the reserve fund, to a better qualified servicer.

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)**

Seller/servicers interested in an open competitive market would prefer to have the excess IO as an asset that is contractually separate from the MSR.

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

An excess IO contractually separate from the MSR should level price realization across various sizes of servicers and originators since they will be valued without the need to estimate the risk of servicer failure. Due to the lack of credit risk and ease of transferability, IOs trade at a lower discount rate (i.e, a higher value) than MSRs. In addition, it is likely that the default risk is significantly overestimated for smaller originators leading to reduced values and liquidity for MSRs sold by smaller originators.

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

Yes. Contractually separating the excess IO should create more liquidity and price transparency. See 3.a. above. Being separated from the underlying servicer, IOs have greater homogeneity than a comparable MSR and are therefore more tradable, i.e., liquid.

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?**

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, is beneficial to the industry. Contractually separated IOs will have enhanced liquidity and a lower discount rate resulting in a higher IO value. According to micro-economic theory, this excess value should be shared by the originator and the mortgagor in the form of a lower borrowing cost for consumers.

We are not aware of any empirical evidence suggesting a positive correlation between investment in MSRs and the quality of servicing. In fact, just the opposite may be the case as high touch, special servicers are often regarded as the highest quality servicers, and they generally don't own MSRs.

For large and small players alike, the activities of MSR valuation and hedging are a distraction to the servicer's essential servicing operations. Servicers free from the financial management activities associated with managing MSR/IOs can focus their efforts on investing in origination and servicing technology, improving their servicing effectiveness and efficiencies and building capability to quickly respond to adverse economic conditions.

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

As stated above, we do not believe that there is a demonstratable link between MSR ownership and servicing quality. While more clarity is required on how non-performing loans are going to be handled under either Option, establishing a robust servicing market where the servicers are paid a fair servicing fee (but not an IO unless the servicers chose to retain the IO) for providing performing and non-performing loan servicing will establish healthy competition for servicing that ultimately leads to better performing and non-performing loan servicing in both strong and weak economic cycles. The inclusion of the Reserve Account concept in the 'Fee for Service' proposal, as advocated by the MBA and supported by us earlier in this document, will enable the Enterprises to pay for the higher cost of servicing non-performing loans.

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

The fee for service proposal aligns servicing revenues with servicing costs and allows for servicers to make a fair profit. Servicers have the incentive, in the form of a reserve account release, to deliver high quality servicing and reduce defaults. Moreover, the guarantor retains the flexibility to change the servicer if the servicer is not meeting established servicing standards without paying an upfront amount for the transfer of MSRs.

This will eliminate ineffective servicers, reducing loses to the guarantors and improving service to the borrowers.

b) Would this improve service to borrowers?

Yes. The fee for service model ensures that servicers' revenue for defaulted loans are earned via incentive and compensatory fees. These fees and incentives are defined by outcomes that result in improved and consistent borrower service. It is, therefore, in servicer's best interest to improve the quality and consistency of service to the borrowers.

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

There are sound arguments that either proposal could have a positive or negative impact on the TBA markets. (As outlined in our response to 1.a., we believe that Option 2 will have a positive impact on the TBA market by minimizing lender induced refinancing.) TBA markets, however, are extremely liquid and have sophisticated market participants. FHFA's 'Fee for Service' proposal supports a wide range of IO strip retention options. We believe that market efficiency will lead to a discovery regarding the preferred amount of IO retention, a possibility contemplated only under Option 2.

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

The net tangible benefit test and monitoring the relative prepayment performance of servicers will help mitigate the negative impact on the TBA market as it ensures that prepayment behavior is more a function of favorable economic conditions to the borrower rather than due to originator/servicer solicitation with the intention of increasing origination revenue.

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

Any step that reduces uncertainty to investors would improve liquidity in the TBA market. The current steps outlined (i.e. net tangible benefit test for refinance, monitoring and tracking prepayment speeds, restricting the amount of an IO in a pool) should help reduce the uncertainty emanating from the fee structure change under Option 2 and assure continued liquidity in the TBA market.

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

   b) A net tangible benefit test for streamlined refinances

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

   d) Limitation of P&I advance requirements

   e) Flexibility for excess IO execution

Each of the options listed above is beneficial to the industry in its own right. However, each of these provisions are most impactful when they are used in conjunction with the “Fee for Service” model with no MSR capitalization.