Servicing Compensation Initiative
pursuant to FHFA Directive

Alternative Mortgage Servicing Compensation Discussion Paper

September 27, 2011

Disclaimer: This discussion document, compiled at the direction of the Federal Housing Finance Agency ("FHFA"), outlines potential alternative servicing models. The information provided in this document is intended for discussion purposes only to obtain comments on two mortgage servicing compensation structures; it does not reflect any decisions regarding an alternative servicing model or a guarantee of future outcomes to the extent an alternative servicing model is implemented in the future. This information is not to be taken as accounting or tax advice or conclusions.

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I. Introduction

The purpose of this Discussion Paper is to propose and seek comments on two new mortgage servicing compensation structures. On January 18, 2011, FHFA announced a Joint Initiative to consider alternatives for a new mortgage servicing compensation structure. FHFA directed Fannie Mae and Freddie Mac, in coordination with FHFA and the Department of Housing and Urban Development (HUD), to consider alternatives for future mortgage servicing structures and servicing compensation for single-family loans. The Joint Initiative's primary goals were:

- Improve service for borrowers;
- Reduce financial risk to servicers; and
- Provide flexibility for guarantors to better manage non-performing loans, while promoting continued liquidity in the To Be Announced (TBA) mortgage securities market.

The general purpose of the Joint Initiative is to explore a number of issues that have been the topic of industry debate and discussion over the years; to evaluate the potential impact on industry participants of alternative compensation structures; and to submit possible solutions for public consideration. To promote an informed discussion of pertinent issues, FHFA posted an *Issues and Background* document on the agency's web site in February 2011, and offered four illustrative scenarios to stimulate public input. FHFA sponsored a series of listening sessions with interested stakeholders, including mortgage industry participants, consumer advocates, research analysts, trade associations, and federal and state regulatory agencies.

Based on the input received from the public, the Joint Initiative developed and debated several concept proposals. Two such proposals are included herein for public consideration and comment. While this effort is not a notice and comment rulemaking subject to the requirements of the Administrative Procedures Act, FHFA is requesting public input on the proposals for a 90-day review period. Written materials may be submitted to FHFA at Servicing_Comp_Public_Comments@fhfa.gov . FHFA will post the written materials received on the FHFA web site for public review. Information identifying the submitter will be redacted prior to posting, if requested. After the expiration of the review period, and after the Joint Initiative has completed an evaluation of the submitted materials, further details will be provided to the public on potential courses of action.

II. The Mortgage Servicer's Duties and Obligations

In today's market, the servicer's duties and obligations are defined through contractual agreements, generally referred to as Servicing Guides for Freddie Mac and Fannie Mae (together the "Enterprises") and Pooling and Servicing Agreements ("PSAs") for private-label securities (the Servicing Guides and PSAs together "the Servicing Guidelines"). The fundamental responsibility of a servicer is to manage the relationship among the borrower, the servicer, the guarantor, and the investor/trustee of a given loan; however, the specific contractual terms that define a servicer's duties and obligations differ depending on whether the loan backs a security guaranteed by Fannie Mae or Freddie Mac (and is subject to the Enterprises' respective

Servicing Guides), backs a security guaranteed by the U.S. Government, backs an unguaranteed security (a "private label security") governed by a PSA, or is held as a whole loan in an investor's portfolio.

Customer service is a key aspect of managing this relationship. Throughout the life of the loan the servicer is responsible for answering borrower inquiries, dealing with issues relating to changes in borrower circumstances, remitting principal and interest ("P&I"), providing accounting for payments, providing remaining loan balance information, making payments to tax authorities and insurance companies, transmitting tax related information to the borrower, and taking actions in accordance with procedures set forth under the applicable Servicing Guidelines. The servicer undertakes these responsibilities and carries them out regardless of interest rate or economic environment or changes to the governing Servicing Guides of the Enterprises, which are subject to change, or additional state or federal government requirements. Servicers assume the risks of such changes.

The scope of the servicer's responsibilities encompasses the entire life cycle of the loan, whether through a payoff, an REO disposition, a third party foreclosure sale, or other ultimate disposition. The servicer is responsible for performing its duties and obligations whether the loan is performing (the borrower is making contractual payments on time) or non-performing (the borrower is *not* making contractual payments on time). Generally speaking, servicing a performing loan is significantly less complex and less expensive than servicing a non-performing loan. Regardless of the status of a given loan, the servicer is responsible for a number of activities that impact the borrower, the guarantor, and the investor/trustee.

A. Performing Loan Servicing

Performing loan servicing is primarily a payments processing business. In general, performing loan servicing is technology intensive and characterized by economies of scale. While there are customer inquiries associated with performing loans, they tend to be more related to operational matters. Absent delinquency, the servicer's activities are largely routine functions.

Key functions associated with performing loan servicing include the following:

- Collecting monthly payments from the borrower;
- Remitting P&I to the investor through the master servicer as required, remitting the guarantee fee to the guarantor, and distributing funds to the escrow accounts for property taxes, hazard insurance, and other obligations relating to the property;
- Making payments from the escrow accounts to the tax authorities, insurance companies, and others;
- Performing administrative functions such as maintaining records that provide a detailed accounting of the loan balance, payment and other activity on the account;
- Reporting to investors/guarantors/trustees;
- Processing lien releases; and
- Responding to payoff requests.

As a result, these activities generally have significant economies of scale resulting from centralized processing operations and automation and technology that enables servicers to focus on operational efficiency. Continued advances in process improvements and automation and technology (e.g., online bill paying) should continue to benefit performing loan servicing.

B. Non-Performing Loan Servicing

In contrast to performing loan servicing, non-performing loan servicing is very labor intensive, and does not have economies of scale benefits typical of performing loan servicing. Non-performing loan servicing involves direct interaction with borrowers and other processes (e.g., default management) that require much more activity and borrower interaction on the part of servicing personnel.

Key functions associated with non-performing loan servicing include the following:

- Advancing principal and/or interest to the investor through the master servicer as required by the Servicing Guidelines when a borrower does not make contractual payments and ensuring that other servicing advances are made to various parties (taxes, insurance, etc.) as needed.
- Initiating contact and working with the borrower to understand the borrower's ability and willingness to pay, their interest in staying in the home, the condition of the property, and explaining options that may be available to the borrower depending on the borrower's circumstances and desires.
- Working to identify solutions (such as loan modifications, repayment plans, and forbearances) for borrowers who do not have the capacity to make their contractual payments on the loan, but who still wish to keep their home and who meet the applicable eligibility criteria of the loss mitigation alternatives. The servicer is required to collect documentation from the borrower, and to evaluate whether the borrower meets the criteria of the Servicing Guidelines for the identified solution. If the borrower meets the criteria, the servicer will attempt to implement the identified solution.
- Working with delinquent borrowers that do not qualify for any of the above solutions to stay in their home, or who do not want to stay in the home, to evaluate alternatives to foreclosure. If the borrower has equity in the property, the servicer can encourage the borrower to sell the home. If the borrower has negative equity and owes more than the property's current value, the servicer can work with the borrower to execute a short sale or take a deed in lieu of foreclosure.
- Referring the loan to foreclosure if the borrower does not qualify for, or chooses to not pursue, foreclosure alternatives. After referring the loan to foreclosure, the servicer is responsible for managing the foreclosure process and working with the foreclosure attorney. The servicer provides customer service to the borrower and protects the guarantor/investor/trust interests throughout the default servicing and the foreclosure process. The servicer is responsible for keeping insurance in force on the property, keeping taxes paid, securing the property from vandalism, inspecting the property at regular intervals, and maintaining the value of the property through preventive

maintenance (e.g., mowing the lawn, winterizing pools, keeping utilities on to prevent deterioration, etc.).

Prior to 2007, servicers were mainly focused on building efficiencies in the servicing of performing loans in order to reduce costs and optimize financial returns. Relatively few chose to invest in the technology, systems, infrastructure and staff needed to service large or rapidly growing volumes of non-performing loans. Consequently, many servicers were ill-prepared to efficiently process the high numbers of delinquencies that occurred after the housing market collapsed. Since then, the servicing industry has increased its investment in the processes and technologies needed to meet the challenge of servicing non-performing loans in today's environment.

Non-performing loan servicing is more manual in nature, involves activities that are very different relative to performing loan activities, and requires investments in both technology and people to manage multiple loss mitigation offerings. Servicers have not realized economies of scale seen in performing loan servicing because of the manual- and labor-intensive nature of non-performing loan servicing. While some aspects of non-performing loan servicing (e.g., borrower contact) may continue to be more labor intensive, there are processes and technology improvements already underway to improve efficiencies for servicing non-performing loans.[1]

III. Current Servicing Compensation Model

The lender determines the amount of servicing compensation at the time of origination, when setting the borrower note rate and determining their best execution. Decision factors include how much cross-subsidization occurs between origination and servicing, and how much excess interest only (IO) strip is retained during securitization (refer to Section IV, *The Relationship between Servicing and Originations* for further details).

A. Revenues and Costs

Specific to the servicing side of the business, a servicer receives compensation in exchange for performing servicing activities specified under the Servicing Guidelines. Under the current servicing compensation model, a servicer's revenues fall into the following categories:

- **Servicing Fee**
  The servicer is compensated with a servicing fee paid from the interest portion of the borrower's monthly mortgage payment. The servicer extracts the servicing fee from the interest portion of the borrower's payment and receives a servicing fee cash flow only when the borrower is making payments.

  Minimum Servicing Fee (the "MSF")
  When a loan is sold into the secondary market for Enterprise or FHA/VA loans, the servicer is generally required to retain a Minimum Servicing Fee ("MSF") of 25 basis points for Fannie Mae and Freddie Mac and 44 basis points for Ginnie Mae (19 basis

[1] Prior, Jon. "LPS Finds New Business from Mortgage Servicer Crackdown." HousingWire, 26 July 2011. http://www.housingwire.com/2011/07/26/lps-finds-new-business-from-mortgage-servicer-crackdown.

points for the GNMA II program) of the outstanding principal balance for fixed rate mortgages. This MSF, along with the other servicing revenue components described below, effectively serves as collateral for selling and servicing representations and warranties for the guarantor. For private label securitizations, annual servicing fees were typically 50 basis points of the outstanding principal balance for subprime loans[2] and 25 to 50 basis points for non-subprime loans.

Excess Interest Only ("IO") Strip
Seller/servicers may receive additional compensation in excess of the MSF. Seller/servicers that receive excess IO do so in anticipation of higher costs of servicing (higher than the 25 basis point MSF), as an investment choice, or to most effectively match the borrower mortgage rate to the pass through rate of a mortgage backed security ("MBS").

In the Enterprise model, at securitization, seller/servicers can determine the amount of cash able to be extracted from the loan sale proceeds versus excess IO retained through their best execution decisions when fitting a loan into an MBS coupon. This execution decision is impacted by the use of buydowns (paying the guarantor cash at time of sale to reduce the guarantee fee paid over the life of the loan) or buyups (receiving up-front cash from the guarantor with an increased guarantee fee over the life of the loan). Post-securitization, the servicer may also choose to monetize some or all of the excess IO retained through additional securitizations that may be agreed to and conducted by the Enterprises, while subject to the market's demand for relatively large deal sizes.

- **Float**
  Servicers earn float interest income from escrow balances, monthly principal and interest payments, and payoff balances in interest-bearing accounts prior to remittance to the master servicer, tax authority, or insurance company.

- **Ancillary Fees**
  Servicers are also entitled to certain ancillary fees under the Servicing Guidelines, which include, among other things, late fees assessed on delinquent payments, charges for issuing payoff statements, fax charges, biweekly payment fees, and advertising supplement fees.

- **Incentive Compensation**
  In certain instances and programs, servicers can also earn revenue in the form of incentive fees available under proprietary modification programs (generally in accordance with the Enterprises' Servicing Guides) and through federal government modification programs (e.g., the Home Affordable Modification Program ("HAMP")).

- **Additional Compensation**
  Servicers earn revenue in the form of additional compensation for services rendered, such as assumption fees, and may earn additional compensation from cross-marketing products to borrowers.

[2] Cordell, Larry, et al. "The Incentives of Mortgage Servicers: Myths and Realities." Finance and Economics Discussion Series, Divisions of Research & Statistics and Monetary Affairs, Federal Reserve Board, Working Paper 2008-46, 8 September 2008, page 15. http://www.federalreserve.gov/pubs/feds/2008/200846/200846pap.pdf.

As a result of the compensation structure described above, a servicer is incented to keep loans current, or to restore loans to a performing status, in order to maintain their servicing fee cash flows.

A servicer's expenses generally fall into the following categories.

- **Direct Servicing Costs**
  These costs include personnel, occupancy and equipment, outsourcing and other miscellaneous expenses associated with servicing a loan and include performing all servicing duties stipulated in the Servicing Guidelines. These costs include both servicing performing and non-performing loans.

- **Advance Funding**
  The Servicing Guidelines may require servicers to advance to the investor through the master servicer monthly principal and/or interest payments not made by delinquent borrowers. Additionally, with certain investors/guarantors/trustees or Servicing Guidelines, servicers must also advance interest payments based on the timing of payoffs (compensating interest) or fund advances for tax payments, hazard insurance premiums, etc. if a borrower's escrow balance is not sufficient to cover such payments. The servicer incurs the costs of financing such advances.

- **Carry Costs for Foreclosure and REO-related Expenses**
  Generally, default-related fees are incurred by the servicer and are subsequently reimbursed by the investor through the master servicer. Reimbursable expenses include attorney fees, foreclosure costs and expenses (eviction costs, posting costs, certified mail, recordation, etc.), tax and insurance advances, utility payments and property preservation and inspection fees. The extent of reimbursement varies depending on whether the insurance or guaranty applicable to a particular loan is full or limited in scope.

- **Mortgage Servicing Right ("MSR") Asset Income Statement Impacts**
  MSR assets are capitalized at fair value at time of loan sale/securitization. Holders of MSR assets can elect one of two accounting models for Day 2 accounting: amortization or fair value. Both models create the risk of earnings volatility leading some MSR holders to hedge their MSR. (MSRs are described in more detail in Section B, which follows this section).

  MSR Amortization
  Under the amortization method (i.e., lower of cost or market ("LOCOM") accounting), the reduction in the cost basis in the MSR asset is reflected as amortization expense each period. Additionally, at the end of each period, the holder must assess that cost basis relative to its fair value. Any impairment established from that assessment must also be recorded through income.

  Fair Value Gains/Losses
  Alternatively, holders of MSR assets may elect to carry their MSR assets at fair value, whereby the net change in fair value is reflected in the income statement each period and reflects all changes in fair value including both market and run-off.

- **Hedging Expenses**
  MSR values are highly volatile and sensitive to interest rates and default assumptions. If the servicer chooses to hedge the value of an MSR asset (see discussion later in *Mortgage Servicing Right Volatility*), the servicer will incur hedging expenses associated with the instruments utilized in the servicer's hedging strategy.[3]

B. Mortgage Servicing Rights

Establishment of a Mortgage Servicing Right

The cash flows associated with servicing the loan are created when a loan is sold and a servicing fee is established via a contract, resulting in the creation of an MSR. These cash flows are accounted for separately from the loan when the loan is sold to a third party (investor/guarantor/trustee) and the servicing is retained. This process is referred to as selling loans "servicing retained".

The governing accounting literature requires capitalization of a servicing asset at fair value if the expected net profit (based on ongoing servicing "compensation", including float, ancillary fees, contractual servicing fees, excess IO (if applicable) and any other compensation linked to the Servicing Guidelines, such as Servicing Alignment Initiative ("SAI") incentive compensation, less the cost to service and the financing of advances) exceeds "adequate compensation" (i.e., the expected net profits for a replacement servicer). The adequate compensation fair value estimate is a market concept, that is, it reflects market costs to service and other market assumptions.

Under the current structure and accounting guidelines, the 25 basis point minimum servicing fee plus the float, ancillary, and incentive income are deemed to generate an expected net profit in excess of what a replacement servicer would demand in the market. Accordingly, the current cash flows are deemed to be more than adequate compensation resulting in a capitalized asset.

Mortgage Servicing Rights Valuation and Ongoing Accounting

The MSR asset reflecting the full fair value of the expected net profits is capitalized at sale/securitization and is either (i) carried at fair value with changes in valuation recorded in current period income or (ii) amortized and current period impairment adjustments are made to the extent fair value is less than the amortized cost. Either way, the initially recognized asset is ultimately "expensed" as amortization/impairment or run-off through mark-to-market. Actual income and expense for the servicer are recognized as earned or incurred over time. The net impact is that the final net income equals actual cash income and expenses.

Valuing an MSR is a complex undertaking, primarily because a robust, liquid market for trading MSRs has not existed for many years. As a result, servicers employ different valuation methodologies and analytical techniques, and must use management judgment when developing MSR valuation assumptions and determining the fair value of the MSR asset. This results in a range of MSR values at capitalization and ongoing fair value measurement among servicers.

[3] The hedging may result in gains or losses.

In estimating fair value of MSRs, market participants generally use a Level 3 model-based fair value approach. Level 3 financial assets and liabilities consist primarily of financial instruments for which there is limited market activity and therefore little or no price transparency. As a result, the valuation techniques used to estimate the fair value of Level 3 instruments involve significant unobservable inputs, which generally are more subjective and involve a high degree of management judgment and assumptions. The key model assumptions used in valuing MSRs are typically interest rates, prepayment speeds, and discount rates/Option Adjusted Spread ("OAS") levels. These assumptions are not entity specific assumptions but instead are market-based, consistent with the fair value notion. Market participants have a broad range of views of these assumptions resulting in fair values that have a wide range due to the lack of price transparency.

At any point in time, the MSR valuations may vary widely among institutions. For example, industry feedback has suggested different lenders could have 2 times to 4 times the difference in MSR valuation multiples (i.e., the fair value per basis point of servicing fee calculated as the fair value of servicing—present value of expected net cash flows from servicing—divided by the total serviced principal balance divided by the servicing fee in basis points). This wide range impacts origination dynamics (via borrower note rates offered, implied economic return, and the net income at origination) as well as subsequent servicing dynamics (net income from servicing amortization, mark-to-market, and net hedging gain/losses).

The importance of the initial MSR value is reflected through the competitive gain on sale and borrower note rate. If a market participant estimates the MSR fair value at a higher value, they may be able to offer a lower note rate to a borrower and still maintain the same or higher margin as another market participant with a lower estimate of MSR fair value. However, regardless of the initial value of the MSR, the cash flows over time and what ultimately gets realized will determine the economics (including the interim impacts on financial reporting and capital), and not the amount capitalized for accounting purposes.

Mortgage Servicing Right Volatility

The value of an MSR is volatile due to the interest-only nature of servicing compensation. The cash flow from the servicing fee is extremely sensitive to mortgage prepayments that generally increase when mortgage interest rates fall and decrease in rising interest rate environments. As a consequence of this sensitivity, an MSR asset exhibits a quality known as negative convexity, meaning there is more downside risk than upside benefit driven by the prepayment option embedded in a mortgage and the resulting MSR asset. The value of the MSR will tend to rise when mortgage interest rates rise and prepayments fall, and its value falls when rates fall and prepayments rise. MSR values are also sensitive to assumptions related to credit performance; that is the rate of default assumed and expected cost to service have a direct impact on the expected net profits reflected in the MSR valuation.

An MSR's interest rate sensitivity forces the holder to make choices regarding whether to hedge the position or not. Most servicers tend to hedge the expected change in MSR asset value for multiple interest scenarios to limit earnings volatility resulting from recognition of the change in MSR asset value to earnings. MSR asset hedging programs typically involve using a combination of derivatives such as swaps, swaptions, and Treasury Note futures and available for sale ("AFS") securities that produce a risk profile that is expected to partially offset the

expected change in the MSR asset value. Most servicers have found no perfect hedge exists for the MSR asset. Even "natural" hedges, such as a servicer's ability to leverage the production franchise to produce origination earnings in a refinancing market, have challenges as a result of timing differences between the recognition of origination earnings and the write-off of the MSR asset as a result of borrower refinancing activity.

Managing an MSR hedging program can be costly as it requires specialized interest rate risk management skills and analytical tools, use of hedging instruments with embedded options, rebalancing of hedging positions, and regulatory and economic capital for certain hedging instruments such as AFS securities. As there is no perfect hedge for the MSR asset, servicers have experienced significant earnings volatility related to the MSR asset even when actively hedged. Notably, accounting for any hedging activity related to an MSR asset takes place at the corporate level of the firm (either Treasury or Secondary Market Departments, depending upon skills sets at the individual firm) and may not be reflected in the P&L of the Servicing Department. It is also not a cost item to the Servicing Department. As a result, an organization's costs to hedge MSR assets are not readily transparent in the organization's consolidated financial statements.

In summary, the interest rate sensitivity of the MSR asset has created complexity, cost, and earnings volatility that has little to do with actual loan servicing, the majority of which is an operational process of record-keeping and payment processing for performing loans, and a more labor- and resource-intensive process for non-performing loan servicing.

Capital Issues

There are differences in the way that banks and non-banks are treated in terms of capital charges on MSRs. Under the current regulatory capital structure, banks owning an MSR asset (directly or indirectly through a bank-owned subsidiary) are required to hold approximately 17% of regulatory capital against the MSR asset.[4] The 17% reflects 100% capital for the first 10% of the MSR fair value and 8% capital, based on 100% risk weighting, for the remaining 90% (10% MSR x 100% plus 90% MSR x 8% = 17%). However, capital held against intangibles (including MSRs) cannot constitute more that 50% of total Tier 1 capital. Any amount above 50% is deducted from capital. Thus, MSRs above the defined threshold require a prohibitive 100% equity funding. Moreover, not all banks are equally capital-constrained, even though they face similar capital requirements.

In December 2010, the proposed Basel III Accord was finalized which, if adopted by U.S. banking regulators, will result in a new regulatory capital regime for MSR assets. Under the Basel III Accord, the amount of MSRs that can be counted as Tier 1 capital is capped at 10% effective January 1, 2013, with a phased implementation through 2018. In addition, a bank must deduct the amount by which the aggregate of the following three items exceeds 15% of Tier 1 capital: (i) significant investments in unconsolidated financial institutions; (ii) MSRs; and (iii) deferred tax assets arising from temporary differences. The exclusions from the 10% and 15% thresholds will be phased in from 2013 to 2018.

[4] Regulatory capital requirements may differ for non-bank entities.

Basel III as currently proposed (and fully phased in) will increase required capital for most entities but will significantly increase the effective capital requirements for entities with large MSR positions relative to their Tier 1 capital. Under Basel III, for those institutions at or above the 10% of Tier 1 capital level, the marginal capital requirement is effectively 100%.

The net effect of Basel III is potentially a significant increase in capital requirements for the industry as a whole. Some of the largest originators, who are market leaders in setting mortgage rates, will need to either raise the mortgage rate offered to borrowers while reducing servicing released premiums paid in order to compensate for any incremental capital required, or accept lower returns. If these largest originators, who lead the market at setting borrowers rates, raise the mortgage rate, competitors may adjust their rates accordingly to manage their growth aspirations.[5] Alternatively, entities near or above the 10% threshold may look for other solutions to manage the 10% capital limitation, including acquisition/merger, selling the MSR, and structuring and/or holding more loans on balance sheet (eliminating the recognition of a separate servicing asset).

At the industry level, the increased capital requirements under Basel III may also be partially offset by redistribution of market share. This redistribution could take place through a decrease in servicing released sales, or other servicers acquiring significant share of servicing released activity previously captured by those close to or over 10% of their Tier 1 capital.

Counterparty Risk Management: MSRs as Collateral for the Enterprises

When a servicer enters into a contractual relationship with the Enterprises to sell and or service loans, the servicer agrees to representations and warranties for loan quality and loan servicing. These representations and warranties include meeting identified loan criteria for loan delivery, underwriting and origination, and meeting certain servicing standards for servicing. The Enterprises retain the right to terminate the servicing contract and resell the servicing rights to service the loans, so that the proceeds from the sale of the MSRs can be used to offset the Enterprises' financial exposure to the servicer. In this way, the MSR has historically served as collateral to offset those representations and warranties held by the servicer.

Taxation Matters: IRS Safe Harbor

Currently, the capitalization of the MSR (i.e., the upfront recognition of the expected net profits as a component of the gain on sale) impacts GAAP[6] net income with corresponding GAAP taxable income. Since the capitalization of the MSR represents a non-cash event, paying cash taxes on the non-cash GAAP income at the time of sale would create a heavy cash burden on loan seller/servicers.

To address this timing difference between upfront non-cash net income and corresponding tax obligations, the IRS has historically allowed seller/servicers to elect to utilize a "Safe Harbor" provision. The Safe Harbor is narrowly defined to include only specific MSF levels (25 basis

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[5] For example, competitors seeking to maintain their relative market share and not grow their own books may match the rate increase; the borrower would therefore bear the cost. Alternatively, competitors seeking to grow may offer discounted rates.

[6] Generally Accepted Accounting Principles

points for conventional single-family fixed-rate loans and 37.5 basis points for conventional single-family ARM products).

Under the Safe Harbor, the MSR's expected net profit at origination is not recognized in the calculation of taxable income for tax purposes initially and is instead recognized as taxable income as servicing cash flows are realized, thus aligning the payment of taxes with the timing of the cash flows of the servicing contract. The tax Safe Harbor does not reduce overall taxes paid, but it does change the timing of when those payments are required.

Reducing the MSF to a level which does not result in the capitalization of an MSR asset for GAAP accounting purposes and monetizing any interest cash flow in excess of the new minimum requirement effectively accomplishes the same goal as the tax Safe Harbor - matching the timing of cash taxes due with cash inflows. However, whether or not a tax Safe Harbor will be available for any retained interest cash flow in excess of reduced MSF would be subject to any future guidance issued by the IRS.

C. Other Servicing Contract Features

<u>Guarantor/Master Servicer Rights: Compensatory Fees, Servicing Transfers, Termination</u>

The guarantor/trustee, as a party to the related Servicing Guidelines, has specific rights that may be exercised in the event a given servicer is failing to service loans properly and/or is otherwise not fulfilling applicable contractual obligations. For example, depending on the terms of the Servicing Guidelines, the guarantor/trustee may impose compensatory fees on servicers for inadequate performance, including a lack of complete, timely default management and accurate reporting.

Under certain conditions, the guarantor/trustee may have the right to transfer servicing portfolios and terminate the contractual rights of the servicer. The guarantor/trustee may terminate a servicer either with or without cause, or suspend a servicer based upon certain events or performance-based measures. These include failure to meet the guarantor's net worth requirements, failure to service in accordance with the Servicing Guidelines or to meet certain other eligibility requirements, etc.

Typically, for loans owned by the Enterprises, the succeeding servicer must assume all liability for the selling and servicing representations and warranties, and the prior servicer remains liable as well. When the guarantor/trustee forces a transfer of servicing, the servicing fee is no longer paid to the terminated servicer; rather, a new servicing fee is established with the succeeding servicer.

IV. The Relationship between Servicing and Originations

Historically, mortgage origination and servicing have been closely linked as the value obtained from mortgage servicing under the current servicing compensation model often serves as an offset for origination costs and the anticipated cost of servicing is embedded in the borrower's mortgage rate.

While some portion of servicing compensation is set prior to loan origination, in today's compensation model a seller/servicer also controls some aspects of compensation. Originators set the mortgage rate offered to the borrower (in terms of spread above the par TBA price, net of the guarantee fee), that includes the MSF and any excess IO (if applicable) to provide for an acceptable all-in risk adjusted return on capital for both origination and servicing.

The level of spread charged in the mortgage rate for origination and servicing is based upon competition, the expected costs to originate and service, and the required returns of the originator. The spread covers expected costs of servicing, including performing and non-performing loan servicing. To the extent the level of servicing costs exceeds expectations priced into the acquisition of the MSR, the servicer will realize a lower return and vice versa.

While significant incentive compensation has been offered in certain instances by the guarantors and the government in the current credit cycle (e.g., HAMP) and additional activity-based incentives have been announced by the Enterprises under SAI, the servicer traditionally has borne the direct risk that servicing requirements become more stringent or that the level of non-performing loans exceeds expectations set when the mortgage rate was determined.

As discussed previously, a current challenge is that although the servicer had assumed those risks, the lack of servicer investment in improving non-performing loan servicing led to a need for enhanced incentives paid to the servicers, and the ultimate cost of poor servicer performance has adversely affected the guarantors/investors/trustees and the overall housing market.

Exhibit 1: Illustrative Current Model Originator Cash Flows and Accounting[7]

#	Illustrative Loan/MBS	
1	Note rate	6.00
2	Guarantee fee	(0.20)
3	Minimum servicing fee strip	(0.25)
4	Excess servicing/spread	(0.05)
5	MBS rate	5.50

#	Cash flows at origination:	
6	**Pre-tax cash flows:**	
7	Net cost to originate	(0.88)
8	Excess servicing monetized	0.20
9	Net pre-tax cash flow	(0.68)
10		
11	**Tax cash flows:**	
12	Taxable income	(0.68)
13	Tax cash flow @35%	0.24
14	**After-tax cash flow**	**(0.44)**

#	Origination Accounting (GAAP):	
15	TBA	100.00
16	MSR - minimum servicing fee	1.00
17	MSR - net float/ancillary/cost to service	0.28
18	Excess servicing monetized (cash)	0.20
19	Net cost to originate	(0.88)
20	Net proceeds	100.60
21		
22	Loan funding:	(100.00)
23		
24	**GAAP Gain/(Loss) on sale - pre-tax**	**0.60**
25	**GAAP Tax (35%)**	**(0.21)**
26	**GAAP Gain/(Loss) on sale - post-tax**	**0.39**

The spread between the borrower rate and the MBS rate, net of g-fee, combined with float & ancillary income provides the net revenues required to provide for the return on both origination and servicing operations. The Gain on Sale recorded represents the present value of the expected profit on both origination and servicing.

Loan origination and sale often requires an up-front use of cash even though it may be GAAP net income positive. The ultimate realization of the GAAP Gain on Sale depends upon actual borrower prepayments.

The MSR tax Safe Harbor reverses the GAAP Gain on Sale arising from the capitalized MSR to re-align the taxable income (line 12) with the timing of actual servicing cash income & expenses (line 9). However, book (GAAP) tax follows book income (line 24).

The largest component of the MSR asset is the fair value of the 25 bps Minimum Servicing Fee ("MSF") strip. Historically, for performing loans, net float & ancillary income on a present value basis have exceeded the present value of the cost to service in most cases.

If excess servicing were held instead of being monetized (line 18), the fair value of this additional strip would be included as part of the MSR asset.

Ongoing Accounting & Cash Flows – High Level

- **Amortization expenses of the capitalized MSR asset over time (may be part of below MTM)**
- Mark-to-market ("MTM") of MSR (primarily due to changes in prepayment expectations impacting the fair value of the MSF)
- Receive and recognize cash servicing incomes/expenses (and pay cash taxes)
- Incur cost of required capital

Current mortgage industry practice utilizes a representation and warranty model as a component of quality assurance and compliance with contractual terms. Under this model, there is limited post purchase confirmation of loan quality through loan-level reviews. Instead, the guarantor and investor rely on representations and warranties from the originator/seller that the loans meet applicable eligibility and underwriting guidelines required by the guarantor or in the PSAs. Under most current structures, the servicer is responsible for both the selling *and* servicing representations and warranties, and may look to the seller for reimbursement in the case of breaches of selling representations and warranties. The selling representations and warranties pertain to the loan characteristics; and the servicing representations and warranties pertain to servicing-related requirements, such as adequate infrastructure and qualified staff necessary to meet the servicer's many obligations and its ability to perform servicing activities as required in the Servicing Guidelines. If the servicing is transferred to another servicer, the transferee servicer generally must agree to assume the selling and servicing representations and warranties and associated liabilities.

[7] Refer to the following document for details on the assumptions used in this illustrative example: http://fhfa.gov/webfiles/19719/FHFA_Servicing_Initiative_-_Background_and_Issues_2011-02-14_3pm_FINAL.pdf

V. The FHFA Joint Initiative on Servicing Compensation

A. Overview

As stated in the Introduction, the goals of the Joint Initiative to consider alternatives for a new mortgage servicing compensation structure are to (i) improve service for borrowers; (ii) reduce financial risk to servicers; and (iii) provide flexibility for guarantors to better manage non-performing loans, while promoting continued liquidity in the TBA mortgage securities market.

In addition to those primary goals, the Joint Initiative has been broadly guided by other goals. One such goal is to evaluate whether changes in servicing compensation could lead to enhanced competition in the market for originations and servicing. While it is clear that some aspects of the servicing business benefit from substantial economies of scale, questions have been raised regarding whether the creation of an MSR asset that is not associated with many servicers' core competency has limited participation and acceptance in the servicing market.

Another broad goal has been to consider changes to servicing compensation in the context of application to the broader housing and mortgage market. The Enterprises are operating in conservatorship, and during this period, regardless of their ultimate resolution, FHFA has directed them to work on a number of initiatives with the goal of considering changes to their operations that would be beneficial to the overall housing and mortgage market.

Issues regarding changes in mortgage servicing compensation have been the topic of industry debate and discussion over the years. The issues highlighted include.[8]

- Volatile MSR returns, with imperfect and sometimes prohibitively costly hedges;
- A capital intensive MSR asset, requiring approximately 17% bank regulatory capital, which may potentially be exacerbated under Basel III;
- Level 3 asset valuation of the base MSR, lacking valuation transparency making it difficult for regulators, independent risk managers and analysts to form consistent opinions as to accuracy and fairness of value; and
- Exits from the mortgage business prompted by capital intensive investment and volatile returns, leaving the Enterprises with concentrated risk to large servicer default.

There have been several attempts over the last several years to change the mortgage servicing compensation structure driven by many of the same reasons noted above. In 2003, several sellers/servicers proposed reducing the MSF from 25 basis points to 12.5 basis points, however, market consensus did not materialize and the reduction did not occur on a wide scale basis. In 2008, the MBA proposal for Alternative Minimum Servicing Fee put forward by a consortium of mortgage banks proposed changing the MSF to equal 1% of principal and interest payments. Due to significant market changes and the financial crisis, the proposal did not gain traction and did not result in a change to the MSF structure.

[8] These issues were also raised in the referenced 2008 Proposal on an Alternative Minimum Servicing Fee.

B. Public Feedback

To promote an informed discussion of pertinent issues, FHFA posted an *Issues and Background* document on the agency's web site in February 2011, and offered four illustrative scenarios to stimulate public input. FHFA sponsored a series of listening sessions with interested stakeholders, including mortgage industry participants, consumer advocates, research analysts, trade associations, and federal and state regulatory agencies. During the course of those listening sessions, feedback centered on several general issues, summarized below.

- Some participants in the public feedback process expressed concerns over the fragile state of the housing market, and concerns that a change in the manner in which servicers are compensated would further complicate an uncertain landscape.
- Some participants expressed concerns over the potential impact on the TBA market of changes in the 25 basis point MSF. Those participants questioned whether reducing the required servicing fee would lead to additional incentives for servicers to refinance existing borrowers, which could reduce the value of the securities.
- Some participants expressed concerns that certain changes in the mortgage servicing compensation structure—specifically, a reduced MSF—would result in further consolidation in the servicing industry. They feared that servicers without significant economies of scale would suffer if the servicing fee were significantly reduced. They extrapolated that the end result would likely be the elimination of small- and medium-sized servicing entities for whom servicing would no longer be profitable or viable.
- Participants were virtually uniform in their support for bifurcating the selling and servicing representations and warranties. According to these participants, the inability to split representations and warranties is a hurdle to transfers of servicing portfolios. Successor servicers are reluctant to accept a transfer of servicing because of the requirement to accept the origination representations and warranties, and this hinders the transfer of servicing portfolios (and non-performing segments of servicing portfolios) in circumstances where a potential successor is concerned that a transferring servicer may have failed to meet required servicing performance standards.
- Participant views on holding a capitalized MSR asset were not uniform. Many participants viewed a capitalized MSR as an important component of their business model. Some participants viewed a capitalized MSR asset as contributing to earnings volatility and subject to capital constraints, which reduces their desire to be active in the servicing market.

The next section describes two alternative servicing compensation models for which the Joint Initiative is seeking further comment.

VI. Alternative Servicing Compensation Proposals

A. Conceptual Overview of the Current Servicing Compensation Model

Today, servicer compensation is based on the originator setting the mortgage rate offered to borrowers (in terms of spread above the par TBA price, net of the guarantee fee), that when combined with the other cash flows associated with servicing and origination provides for an acceptable all-in risk adjusted return on capital for both origination and servicing. The level of spread charged in the mortgage rate for origination and servicing is based upon competition, the expected costs to originate and service, and the required returns of the originator and servicer. The spread covers the expected costs of servicing, including non-performing loan servicing. To the extent servicing costs exceed expectations, the servicer will realize a lower return than expected, and vice versa.

The servicer collects payment via a servicing fee from the interest portion of the borrower's mortgage payment in the case of a performing loan (i.e., when the borrower actually makes a payment). In the case of a non-performing loan, the servicer receives no servicing fee cash flow (other than incentive payments, if earned) because there is no borrower payment from which to extract the servicing fee. In either case, the guarantor/investor/trustee evaluates the quality of servicing by monitoring the servicer's performance against a series of performance measures as outlined in the related Servicing Guidelines. The guarantor/investor/trustee may exercise their applicable contractual rights if the servicer breaches the terms of the Servicing Guidelines.

In order to understand the proposed context, it is important to frame the following fundamental aspects of the current compensation framework:

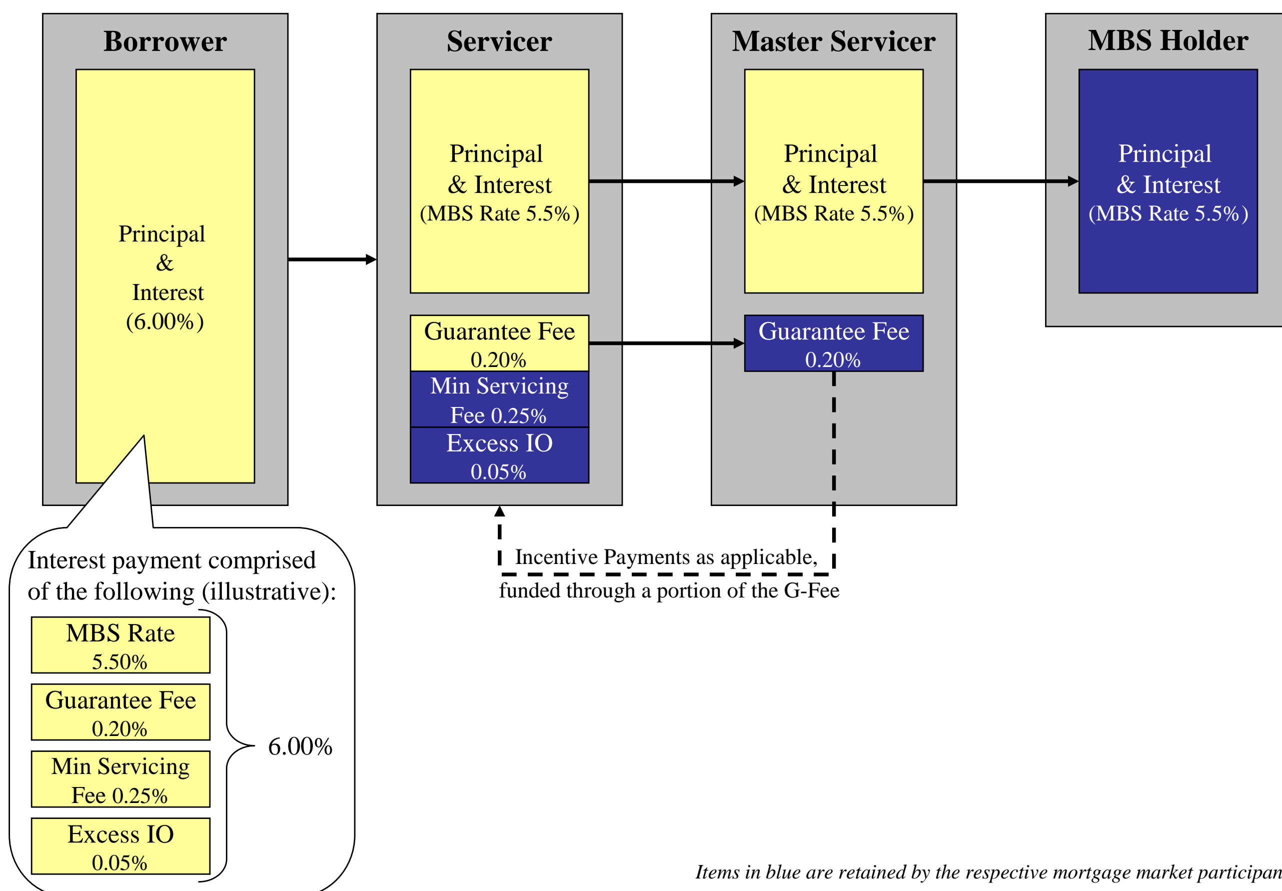
- The MSR represents cash flows that are analogous to an IO security, but the servicer's right to receive these cash flows is dependent upon its continued performance under the Servicing Guidelines. The mortgage servicing right is typically a GAAP asset on the servicer's balance sheet.
- The 25 basis points MSF is effectively a required retained interest in the loan that effectively serves as collateral for the Enterprises and sets a minimum level of ongoing cash flow compensation pursuant to the Servicing Guidelines. This retained interest is largely an IO retained investment in the loan. IO instruments are high volatility and high-risk investments (subject to significant prepayment risk with no return of principal) with corresponding higher ex-ante return expectations. As a result, changing the MSF does not create or eliminate revenue to the servicer; instead it changes the timing of when the revenue is received in cash, and the corresponding tax treatment.
- The requirement to hold a minimum 25 basis point interest strip in each loan serviced requires that a servicer have both the ability and willingness to be a significant IO investor. This IO investment is economically volatile, capital intensive, and requires strong risk management expertise (e.g., hedging). The financial risk management skills and capital required for the IO investment component are not core competencies for providing quality servicing.
- When setting the mortgage rate to borrowers, the originator prices into the note rate expectations about future levels of default and related servicing costs. Any increase in

default servicing costs over those assumed and priced for, whether resulting from changes in servicing requirements and/or higher than expected defaults, results in the servicer realizing lower than expected returns.

- The MSR is a capitalized asset by definition because the ongoing compensation, including float, ancillary fees, contractual servicing fees, excess IO (if applicable) and any other compensation linked to the Servicing Guidelines, such as SAI incentive compensation, exceeds market compensation for the equivalent services. In normal credit cycles, the compensation stream contractually tied to servicing as collateral is multiples of the cost to service. Even in this historic credit cycle with significantly higher default servicing costs, the current servicing compensation framework results in a mortgage servicing asset for most entities.

- The recent housing and mortgage finance crisis—and government programs intended to benefit delinquent homeowners—revealed a number of issues in the current servicing model and increased the cost to service. Although servicers benefitted historically from a large spread between servicing fees and their costs to service, many servicers failed to invest appropriately in technology, systems, and infrastructure because it would have increased their servicing costs and, under certain accounting rules, led to the write down of the MSR asset. This made it difficult to accommodate the significant increase in borrower delinquency and default. Servicers became the subject of complaints about their unresponsiveness to borrower, guarantor, and investor needs. The servicers' decision to not develop appropriate infrastructure and processes impaired their ability to efficiently handle the increased volume of delinquent loans and foreclosures. Investigations into servicing practices revealed that certain servicers engaged in activities that did not comport with professional standards or, in some cases, with applicable law, regulations, and local rules. Although improved monitoring of servicer performance and enhanced regulatory oversight may have helped identify these practices earlier, the incentives inherent in the current servicing compensation model contributed to these problems.

Exhibit 2: Current Servicing Compensation Income Flows



B. Modest Changes to the Current Enterprise Servicing Compensation Model: Reserve Account

A different fee structure, in the form of a reserve account, has been proposed by the Mortgage Bankers Association (MBA) and by The Clearing House Association, for study and evaluation as part of the Joint Initiative.

The MBA proposed a reduced MSF (20 basis points) coupled with a reserve account structure designed to alleviate the MBA's concerns that anticipated increases in guarantee fees would be disproportionate to the future cost of servicing non-performing loans. The MBA proposal establishes a separate account within the trust structure of the mortgage-backed security. As contemplated, the account would be funded through the reallocation of five basis points from the borrower's payment, and would be available to pay for non-performing loan servicing. In the event the servicing portfolio was transferred to a successor servicer, the reserve account would transfer as well. If the sequestered funds were not used to offset non-performing loan servicing costs, then the servicer could recapture the funds, based on predetermined criteria. For additional details regarding the MBA's proposal, refer to the MBA's web site at www.mbaa.org.

The Clearing House proposed a reserve account that would be tied to a specific vintage and held in trust by a bankruptcy-remote entity, with unused portions refunded to the servicer if the application of the funds proved unnecessary to cover extraordinary servicing costs. Terms for both accessing and releasing the reserve accounts would be established as part of the Servicing Guidelines. The Clearing House proposal included an example of a three basis points account, in conjunction with a MSF of 12.5 basis points, and included guiding principles related to the reserve account's structure (built over time), segregation of funds (so the account is protected if either the guarantor or the servicer fails), ownership, portability, access, use (for unanticipated costs only), and release of funds in the account. Details of The Clearing House proposal may be found at http://www.theclearinghouse.org/index.html?f=072886 and http://www.theclearinghouse.org/index.html?f=072887.

Since these proposals have a common theme, FHFA is including for public comment the following concept: servicers would retain a reduced MSF strip (ranging from 12.5 to 20 basis points) relative to today's 25 basis points standard, with an additional reserve account (ranging from three to five basis points) to cover non-performing loan servicing costs. This approach has received some support from constituencies that see benefit from introducing change at a slower pace, reducing some capital exposure (if the reserve account is not considered part of servicer compensation and excluded from MSR capitalization), and protecting investors' concerns over "skin in the game" while focusing some attention specifically to the increased costs of non-performing loans. This concept could include the following features:

- The reserve account would "kick-in" after pre-determined thresholds are met. Above-average servicer performance that helps negate the need for the reserve account could lead to a partial or full refund of the reserve account to the servicer, based on pre-determined triggers and performance targets. The triggers are not currently defined, but could include geography-based market conditions, time periods, performance measures, etc. Each servicer would have its own reserve account related to its loans; there would be no cross-collateralization among servicers' reserve accounts.
- The reserve account would move with any transfer of servicing from old to new servicer.
- The reserve account would be subject to the rights of the Enterprise in the event of servicing seizures. The Enterprises' Servicing Guides would be amended to incorporate the terms of any new MSF proposal and related reserve account.
- Selling representations and warranties would be held by the servicer, as they are today, and would transfer with the servicing to the new servicer. Bifurcation would continue to be evaluated and negotiated on a case by case basis, as it is today.
- The servicer bears the risk that the MSF and the reserve account are insufficient to cover the servicer's costs. The guarantor/investor/trustee may directly compensate servicers to cover any resulting shortfall, consistent with current practice.
- The structure will allow for a MSF that would provide a means to accommodate regulatory changes to servicing requirements.
- The structure does not substantially change the nature of the treatment or execution of excess IO from today's model.

The feasibility of this proposal as it relates to capital requirements, accounting and tax treatment, trust considerations, origination economics, and other impacts are not yet determined and warrant further analysis from the industry. The Joint Initiative requests comments from the housing finance experts in the industry regarding the accounting, tax, and other treatment of the reserve account proposed here.

In summary, the reserve account proposal attempts to incorporate concepts discussed in the industry as a mechanism to move forward with more modest changes to the current servicing compensation model. While it is uncertain in its attempt to lessen the impact of capitalization of the MSR, it is a concept that has some support in the industry and warrants further review and comment.

C. Fundamental Changes to the Current Enterprise Servicing Compensation Model: Fee for Service

In addition to the reserve account model, the Joint Initiative identified a new servicing compensation structure that fundamentally differs from the current compensation model. The new structure reengineers the servicing-related cash flows in an attempt to more accurately reflect the interests of the borrower, the servicer, and the investor/guarantor/trustee, and the specific activities the servicer performs. The new proposal could serve as a concept model for loans backing mortgage-backed securities guaranteed by the Enterprises, government-insured securities, and private label securities by better tying compensation paid to the servicer with the actual services performed by the servicer.

This model was also designed to meet the following key objectives of the Joint Initiative:

- Improve service for borrowers;
- Reduce financial risk to servicers;
- Provide flexibility for guarantors to better manage non-performing loans while promoting continued liquidity in the TBA mortgage securities market; and
- Promote enhanced competition in the market for origination and servicing.

The Fee for Service model includes the following features:

- The guarantor will pay a set dollar fee per loan[9] for performing loan servicing.[10] A set dollar fee per loan ties the compensation to the number of loans being serviced which is the predominant driver of servicing costs, not the size of the mortgage. The guarantor will collect a master servicing strip from the interest payments made by the borrower to fund the dollar fee per loan payments to servicers.

[9] For purposes of this discussion paper, compensation level is currently expected to be $10/performing loan and will be confirmed once there is clarity on servicing requirements. An alternative to this model is a basis point model where the compensation for performing loans is based on the outstanding Unpaid Principal Balance ("UPB"). The Joint Initiative is seeking public feedback on this alternative.

[10] Performing loan servicing comprises servicing activities associated with current mortgage loans.

- Servicer has increased flexibility in the level (if any) of excess IO strip that is retained vs. monetized up-front. This provides the originator with flexibility and an option to either reduce the amount of the IO held, or to hold the same amount of IO as today and replicate effectively the same economic position as under today's model.
- Servicer retains ancillary fee income and interest earned on escrow and investor funds awaiting disbursement or remittance.
- For non-performing loan servicing[11], the guarantor will continue to cover the credit risk as it does today.
    - As part of this credit risk management, the guarantor may pay the servicer incentive compensation and assess compensatory fees (e.g., SAI) in order to incent servicer actions/results that better and more consistently serve borrowers and better mitigate the guarantor's loss exposure.
- The structure would allow for regulatory changes to servicing requirements to be assessed at least annually and thus reflected in the servicing cost structure prospectively and in a transparent manner.
- Selling and servicing representations and warranties will be bifurcated.
- The working group has discussed two potential options for managing excess IO cash flows (above the MSF). The two options vary in how they minimize the risk of MSR capitalization, provide flexibility and liquidity to the originator/seller, and impact the management of representation and warranty risk.

  Option A: Excess IO Interest Contractually Tied to the MSR (Status Quo). The seller can choose to retain excess IO or sell it to the Enterprise through a buyup at the time of securitization. The excess IO may be aggregated and sold through subsequent transactions on a negotiated basis with the Enterprises.

    - Retained excess IO will likely be capitalized because it will be in excess of adequate compensation. If this is the case, any market dynamics associated with a capitalized MSR may not change.
    - The seller can choose the amount of excess IO retained between zero and the maximum allowable under pooling requirements.
    - The seller is dependent on the Enterprise buyup bid for liquidity at securitization. Subsequent aggregation and sale of excess IO require negotiation with the Enterprise.
    - The excess IO will transfer to any subsequent servicer when servicing is sold or seized. The excess IO is available to help manage and further offset representation and warranty risk.

  Option B: Excess IO Contractually Separated from the MSR. The seller can choose to either sell excess IO to the Enterprise through a buyup at the time of securitization or receive an excess IO interest which has been separated from the servicing compensation and would not be attached in any way to the servicing contract.

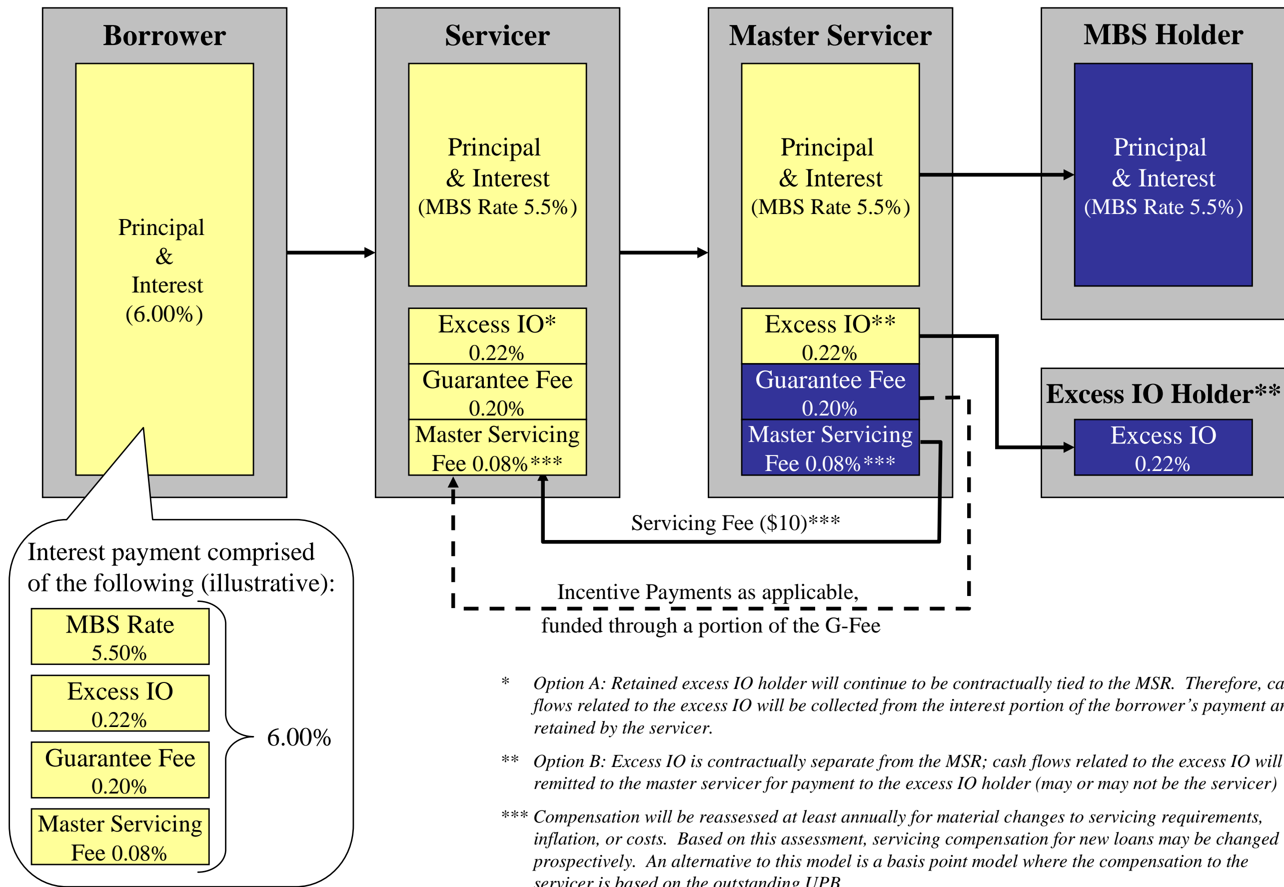
[11] Non-performing loan servicing relates to servicing activities for mortgage loans that are not current.

    - Any excess IO interest held will be an asset on the seller's balance sheet, but will not be a part the MSR; thus, it will not be a part of the adequate compensation assessment. The seller can choose the amount of excess IO to be retained, between zero and the maximum allowable under pooling requirements.
    - The seller is not dependent solely on the Enterprise buyup bid for liquidity at securitization. The seller can either sell to the Enterprise buyup bid, or receive the excess IO interest that can be subsequently sold at any time. To the extent that such a mechanism could be developed to provide pricing that would be relatively equal across varied delivery volume, valuations would be more transparent and consistent, which could help level the playing field.
    - The excess IO interest will not automatically transfer to any subsequent servicer when servicing is sold or seized. The transfer or sale of this excess IO will not be subject to Enterprise approval.

- In order to protect investors by minimizing the perceived risk of faster prepayments or adverse selection due to potential changes in servicer incentives resulting from the reduction of the 25 basis point MSF, the Enterprises will:
    - Implement a net tangible benefit test for streamlined refinance programs;
    - Enhance monitoring and tracking of prepayment speeds for each servicer; and
    - Restrict the amount of excess IO in a given pool.

In addition to the basic elements of this new proposed structure, the term sheet highlights below provide additional details of the Fee for Service model. The full term sheet can be found in *Appendix A*. As noted above, the model described in the term sheet seeks to be flexible to accommodate future changes in servicing requirements and allow for greater servicer participation. At the same time, it provides servicers with similar ability to seek out excess servicing to cover servicing or origination costs.

Exhibit 3: Fee for Service Income Flows



* *Option A: Retained excess IO holder will continue to be contractually tied to the MSR. Therefore, cash flows related to the excess IO will be collected from the interest portion of the borrower's payment and retained by the servicer.*

** *Option B: Excess IO is contractually separate from the MSR; cash flows related to the excess IO will be remitted to the master servicer for payment to the excess IO holder (may or may not be the servicer)*

*** *Compensation will be reassessed at least annually for material changes to servicing requirements, inflation, or costs. Based on this assessment, servicing compensation for new loans may be changed prospectively. An alternative to this model is a basis point model where the compensation to the servicer is based on the outstanding UPB.*

Items in blue are retained by the respective mortgage market participant

Highlights of the Fee for Service Term Sheet

Term Sheet Highlights	Rationale
Guarantor pays set dollar fee per loan[12] for performing loans. Compensation will be reassessed at least annually for material changes to servicing requirements, inflation or costs. Based on this assessment, servicing compensation for new loans may be changed prospectively; this would include potential changes to servicing standards.	• Compensation set at "market" for the defined services providing servicers with market based compensation and likely eliminating the need to capitalize the servicing asset and its associated valuation and hedging complexities of a capitalized MSR asset. • Dollar per loan instead of basis points of UPB reflects recognition of consistent costs per loan regardless of loan size, as well as the transactional nature of the servicing business where costs are driven by the number of loans rather than the outstanding UPB.
No minimum required retained servicing strip thereby providing seller/servicer with the flexibility to determine the amount of excess IO they retain, if any. **There are two options that vary in how they minimize the risk of MSR capitalization, provide flexibility and liquidity to the originator/seller, and impact the management of representation and warranty risk.** • **Option A: Excess IO interest is contractually tied to the MSR (similar to today's model)** • **Option B: Excess IO is contractually separated from the MSR**	• Holding a significant IO strip exposure is no longer a prerequisite to being a servicer. • Seller/servicers decide whether to receive higher proceeds upon sale/securitization or to hold an excess IO strip. • It is recognized that there are legitimate business reasons for choosing to hold some IO investment in loans serviced, including some level of "natural hedge" with the origination business and best execution given market conditions. As such, servicers can choose the level of excess IO exposure maintained with the ability to replicate the current risk/reward cash profile of the 25 basis point MSF. • Allows broader set of lenders to provide customer service for both origination and servicing.
Selling representations & warranties (R&W) will be bifurcated from the ongoing servicing economics. **Original seller to the guarantor will be required to pay additional fee for selling R&W exposure; guarantor will retain all contractual rights and remedies for breach of selling R&W**	• Increases liquidity of servicing by eliminating selling R&W exposure for the servicing transferee. • In the current structure, the servicing seller generally provides for selling R&W to the servicing purchaser but either receives a reduced value for servicing to reflect their counterparty risk to the purchaser or cannot sell the servicing at all. • Provides for more liquid servicing market.

[12] An alternative to this model is a basis point model where the compensation for performing loans is based on the outstanding UPB.

Term Sheet Highlights	Rationale
Additional incentive compensation and compensatory fees provided for non-performing loan servicing. **Compensation may include incentive payments recently announced as part of SAI, other discretionary incentive payments and any additional incentive structures deemed necessary.**	• Incentive and compensatory fees designed to reward specific activities and outcomes that result in improved and more consistent borrower service and best mitigate the guarantor's credit risk exposure. • Incremental revenues provided to servicer to compensate for increased levels of loss mitigation required as well as increases in servicing requirements required by the guarantor.
Servicer P&I advancing requirements will be limited to the point the loan is delinquent four consecutive monthly payments.	• Provides more certainty to the servicer as to required advances. • By limiting P&I advancing exposure, helps smaller lenders provide customer service through retained servicing.
Enhanced rights for the guarantor to transfer servicing based on loan performance. **Additional performance and/or operating metrics to be implemented to provide for basis on when the guarantor has such rights.**	• The guarantor currently faces certain obstacles in moving servicing to protect its credit exposure in the case of at-risk loans.

The servicing fee and the incentive payments would be set at levels that cover the risks inherent in the structure (e.g., basis risk associated with collecting in basis points and paying in dollar per loan and incentive fees) and at levels that generally provide a reasonable return to the servicer for servicing both performing and non-performing loans.

D. Government Loans and Ginnie Mae

Ginnie Mae is a government corporation and its business model differs significantly in function and scope from that of the Enterprises and of any private label securitization structures. Ginnie Mae is an MBS guarantor but it is not an issuer of MBS, does not have a mortgage investment portfolio, does not issue debt securities and does not guarantee or insure at the borrower credit level.

The loans eligible for Ginnie Mae Guaranteed MBS are limited to those that are insured or guaranteed at the borrower credit level by the government housing agencies (FHA, VA, RD or PIH),[13] and Ginnie Mae pools commingle those loans. Ginnie Mae and the government housing agencies all derive their authority from federal statute and regulation. Each agency has its own

[13] Government housing agencies include the Federal Housing Administration ("FHA"), U.S. Department of Veterans Affairs ("VA"), U.S. Department of Agriculture Rural Development ("RD"), and the Office of Public and Indian Housing ("PIH").

statutory, operational, systems and regulatory structures for origination, servicing or the MBS guarantee program.

These government housing agencies receive fees from borrowers for their guarantees and insurance but on different terms from one another. The accounting systems of the housing agencies are not identical and they do not own servicing for loans in pools and do not receive servicing fees for those loans. The housing agencies generally do not have MSFs for their loans. Ginnie Mae sets the MSF for loans in its pools and its program specifies how bond administration is performed. However, Ginnie Mae does not create or administer the origination or servicing standards for the loans since the housing agencies are responsible for loan level credit losses. The loan servicing and the claims processing rules are set by the housing agencies, not by Ginnie Mae, and they are not uniform. Net losses on defaulted loans vary by loan and by agency for reasons related to claims requirements and the nature of the insurance or guaranty of the particular agency or loan program involved.

Because Ginnie Mae differs from the Enterprises in its model, powers and limitations, any change to servicing compensation or to servicer risk exposure would have to be examined by Ginnie Mae, FHA, VA, RD and PIH from the statutory and budget perspectives of the government.

Coordination of Ginnie Mae and the government housing agencies is a different task than is the case at the Enterprises which provide both borrower and MBS level guarantees, hold portfolios for investment, and establish their own origination and servicing standards. The borrowers served by the government housing programs include first-time borrowers, borrowers with impaired credit, veterans entitled to benefits and borrowers located in underserved areas. Traditionally, Ginnie Mae loans are smaller than Enterprise loans and the mortgage size factors into the compensation differential that has existed for years between government and conventional servicing. In addition, for reasons related to borrower default patterns and the relatively lower percentage of reimbursement for losses incurred by servicers, government servicing is generally more costly than conventional servicing. An additional consideration is that Ginnie Mae's lower MSF of 19 basis points, six basis points lower than the Enterprises' MSF, constitutes payment that more closely approximates the cost of servicing Ginnie Mae loans.

Despite challenges specific to the government housing programs, Ginnie Mae remains open to public input on how each of the options described would benefit the Ginnie Mae program.

Ginnie Mae will be working with FHA, VA, RD and PIH to develop better claims mechanisms, more efficient pooling processes and clearer risk and warranty delineation to improve the value of securitization for all participants in the mortgage market from borrowers to investors. Further follow-up and coordination with the FHFA Servicing Compensation Initiative participants, the government housing agencies and Ginnie Mae's program participants and beneficiaries will be part of efforts to improve default servicing. As the servicing environment changes, Ginnie Mae will work with those parties to assure that its securitization program functions to support better servicing. Ginnie Mae is committed to meeting the market's requirements and creating a more

efficient program in support of its primary mission, however complicated the challenges, and the agency is looking forward to the response of the industry to the ideas proposed here.

E. Private-Label Mortgage-Backed Securities

The Fee for Service servicing compensation proposal could also be applied to the private label market. Members of the investment community have argued that a number of changes to the current structure must be sorted out in order to attract private capital back to the securitization business. For example, investors desire loan-level disclosure and periodic loan-level reporting; standardized PSAs (these would include standardized servicer duties and obligations, and uniform definitions of operative terms); standard representations and warranties; and enhanced investor reporting. Many of these changes would require changes in the servicer's contractual responsibilities. Changes in those responsibilities would, in turn, impact servicer compensation.

The private label security market segment suffers from a lack of transparency with regard to the terms of servicing contracts because these contracts, and other deal documents, are treated as proprietary and confidential documents. Although the new servicing compensation proposal would not provide a solution for the full range of items needed to re-start the private label securitization market, it would provide greater transparency around how servicing would be conducted, where the responsibilities are housed, and what remediation options are available. The new proposal ties compensation paid to the servicer with the actual services performed by the servicer. This feature should help alleviate investor concerns that the interests of the investor and the interests of the servicer are not sufficiently aligned. Increased transparency creates greater confidence in the market, and increased transparency is among the factors that will bring private capital back into mortgage securitization. In the private label securities market there is no offset of MSR against representation and warranty exposure.

Today, private label security investors do not exercise direct leverage over the servicer, and do not have a direct relationship with the servicer. These investors do not receive loss mitigation reports, and they do not have the right to review the servicer's loss mitigation decisions. The servicer may be terminated subject to certain events of default, but this must be done with a majority of the investors who direct the trustee to act. Moreover, the trustee function in private label securities is limited to administrative, ministerial actions. The trustee's duties typically do not include active monitoring of the servicer. Thus, to the extent that servicer compensation structure and requirements could be written into the PSA in a manner contemplated by this new compensation proposal, many investor concerns could be addressed.

Topic	General Proposed Terms – Private Label Securities
Base Compensation Structure	▪ Base compensation structure similar to that proposed for Enterprises with the following exceptions: o Servicing fees for performing (dollar fee per loan or basis point fee) and non-performing loans will be first priority in waterfall above P&I o Any shortfall will affect the subordinate tranches first, but may also impact the senior tranches if losses exceed subordination levels
Discretionary Incentives	▪ N/A – does not apply because all incentives would need to be pre-specified in the Servicing Guidelines
Excess IO	▪ N/A – no excess IO in private label security structure
Contractual Requirements	▪ Would require standardized PSA with: o Standard servicer duties, obligations, and incentives established upfront o Consistent representations and warranties (R&W)
R&W	▪ Leverage private label security standard R&W
Prepayment Protection	▪ No change from current structure

VII. Conclusion and Questions for Public Comment

The Joint Initiative considered the broad range of public feedback received in response to the *Issues and Background* document FHFA posted earlier in this year, and formulated two possible servicing compensation designs for additional public comment. These designs would complement the already announced shift towards a performance-based incentive fee for non-performing loans as outlined under the SAI.

One proposal provides for a reduced minimum servicing fee accompanied by a reserve account. The reserve account would be available to offset unexpectedly high servicing costs resulting from extraordinary deteriorations in industry conditions. This proposal represents a modest change to the current servicing compensation model. The second proposal introduces a Fee for Service structure that provides for a base servicing fee for performing loans (either a dollar fee per loan or basis point fee) with the possibility of avoiding MSR capitalization. This proposal represents a fundamental change to the current servicing compensation model.

The proposals vary primarily in the flexibility provided to a lender's allocation decision of the total mortgage banking interest spread between (i) a lowered MSF; (ii) a master servicing fee strip to the Enterprises to pay a fixed dollar fee per loan for performing loan servicing (in the case of a dollar per loan option); and (iii) additional IO retained (excess IO) for performing loans, and (iv) upfront cash.

The Joint Initiative recognizes that any change in the current mortgage servicing compensation model requires careful consideration of the impact of the change on existing business practices, accounting, tax, risk management, and other issues. The analysis of such issues is beyond the scope of this discussion paper. The Joint Initiative now seeks public comment on the two

options put forward, and invites public input on the implications of these options. In particular, some key questions that commenters should focus on in evaluating these two options include the following:

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?

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?
   b) Does the impact vary across various business and interest rate cycles?
   c) Does the impact vary across size of servicers and originators?
   d) Would greater transparency in MSR valuation improve the competitive landscape?
   e) What is the impact of a potential reduction in tax Safe Harbor?
   f) Should the servicer be required to hold a capitalized MSR asset (effectively be an IO investor) as a condition of performing servicing activities?

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) Does the impact from market-based pricing of the excess IO vary across size of servicers and originators?
   b) Does contractually separating the excess IO from the MSR create more liquidity and price transparency?
   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?

4) Would these proposals encourage greater investment in non-performing loan operations or abilities in a benign market cycle?
   a) How does this impact the alignment between guarantor and servicer interests?
   b) Would this improve service to borrowers?

5) What would be the impact of the proposals on the TBA market if there were no MSR capitalization?
   a) To what degree might the net tangible benefit test and other suggested provisions help mitigate any potential negative impact on the TBA market?
   b) What additional steps can we take to 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

Appendix A: Fee for Service Term Sheet

The current contract with the Enterprises will be amended to incorporate the terms outlined in this Term Sheet as necessary.

<table>
<tr><th>Topic</th><th>General Proposed Terms</th></tr>
<tr><td>Base Compensation Structure</td><td>
Servicer receives compensation monthly based on loan status for performing (PL) and non-performing loan (NPL):
<table>
<tr><th></th><th>PL Compensation</th><th>NPL Compensation</th></tr>
<tr><td>Servicing</td><td>▪ $10/loan[14]</td><td>▪ $0/loan</td></tr>
<tr><td>Incentive</td><td>▪ N/A</td><td>▪ Incentives for standard NPL activities/outcomes (e.g., SAI)</td></tr>
</table>

Fees paid to servicer may vary by product type and term
Servicer retains ancillary fee income and interest earned on escrow and investor funds awaiting disbursement or remittance, where applicable
In addition to any standard guaranty fee[15], the Enterprises[16] will collect an additional fee from the interest portion of the monthly loan payment and provide the required servicing compensation, as described above, to the servicer:

<table>
<tr><th>Compensation to Enterprises</th><th>Compensation to Servicer</th></tr>
<tr><td>Master Servicing Fee (8 basis points)
▪ Performing loan compensation
▪ Enterprises' basis risk</td><td>▪ $10/loan for performing loans[14]</td></tr>
<tr><td>Guaranty Fee - Credit Risk:
▪ Existing
▪ Catastrophic</td><td>▪ Incentives for standard NPL activities/outcomes (e.g., SAI)
▪ Incentives at the discretion of the Enterprises, as described below
▪ Catastrophic NPL costs/incentives as warranted</td></tr>
</table>
Compensation will be reassessed at least annually to account for material changes to servicing requirements, inflation, or costs. Based on this assessment, servicing compensation for new loans may be changed prospectively. Enterprises, under direction from FHFA, will implement changes related to servicing compensation.
</td></tr>
</table>

[14] If servicing requirements change, performing loan compensation will be adjusted accordingly to a level intended to be considered adequate compensation. An alternative to this model is a MSF basis point model where the compensation for performing loans is based on the outstanding UPB. Public feedback on this basis point alternative is welcome.

[15] Or notional fee as appropriate associated with whole loan sales to the Enterprises.

[16] 'Enterprises' refer to Freddie Mac and Fannie Mae.

Topic	General Proposed Terms
Discretionary Incentives	▪ There may be opportunity for incremental servicing compensation, beyond the compensation described above, which may be a combination of some or all of the following: o Relative performance incentives (e.g., Freddie Mac's Servicing Success and Fannie Mae's STAR programs), and/or o Other special fees for specific facts and circumstances ▪ The incremental compensation is at the Enterprises' discretion
Contractual Requirements	▪ Performing loan and non-performing loan servicer activities will be defined by the Enterprises through their Guides ▪ Servicer will make P&I advances up to point that loan is delinquent 4 consecutive monthly payments (4 months elapsed since last full monthly installment applied) ▪ Reimbursable expenses will be consistent with current Guides ▪ Standardization of servicing activities and requirements will be achieved through SAI ▪ The Enterprises will have the right to impose compensatory fees for non-compliance with set standards or exercise any of their other remedies ▪ Enterprises have the option to transfer for cause ▪ Enterprises will have an enhanced ability to transfer servicing based on loan performance and other factors

<table>
<tr><th>Topic</th><th>General Proposed Terms</th></tr>
<tr><td>Excess IO</td><td>

Originator continues to set mortgage rates offered and may receive an excess IO interest in the loan
There are two mutually exclusive options regarding whether or not an originator holds the excess IO interest as either part of the servicing compensation or separated from the servicing compensation. These options vary in how they impact the likelihood of MSR capitalization, provide flexibility and liquidity to the originator/seller, and impact the management of representation and warranty risk. Either option would be applied uniformly at an industry level:

<table>
<tr><th></th><th>Excess IO - Option A: (Status Quo)
Excess IO Remains Part of MSR</th><th>Excess IO - Option B:
Excess IO Contractually Separated from the MSR</th></tr>
<tr><td>GAAP Accounting</td><td>▪ Considered part of the MSR for accounting purposes, with likely continued MSR capitalization
▪ Cash flows are factored into adequate compensation assessment</td><td>▪ Not considered part of the MSR, standalone IO security that is accounted for as investment in retained interest
▪ Cash flows are not factored into adequate compensation assessment</td></tr>
<tr><td>Collateral Ownership</td><td>▪ Will not be an asset separate from the MSR; therefore, will be subject to Enterprise approval for transfer
▪ Cannot be freely sold or pledged as collateral without Enterprise approval
▪ If servicing is transferred or terminated, excess IO interest does not remain with lender</td><td>▪ Will become the lender's separate asset after sale/securitization and will not be subject to Enterprise approval for transfer
▪ Can be freely sold or pledged as collateral
▪ If servicing is transferred or terminated, excess IO interest remains with the lender</td></tr>
<tr><td>Best Execution</td><td>▪ Same best execution options as in current model</td><td>▪ Retain best execution options available in current model
▪ Additional flexibility to securitize/sell excess IO to wider set of investors</td></tr>
</table>
</td></tr>
<tr><td>Counterparty Risk and Bifurcation of R&W</td><td>

Enterprises will have minimum net worth requirements for sellers and servicers that will be consistent among the Enterprises
Selling and servicing R&W will be bifurcated

Selling R&W will remain with the Seller – they do not transfer with the servicing

The Uniform Mortgage Data Program will reduce R&W exposure by improving the consistency,

</td></tr>
</table>

Topic	General Proposed Terms
	quality, and uniformity of data that are collected at the front end of the mortgage process – Seller will pay a one-time fee at delivery for the bifurcation of selling R&W ▪ The minimum fee for the bifurcation will be consistent among Enterprises; Enterprises may charge a fee higher than the minimum at their discretion – Enterprises retain all contractual rights and remedies for breach of selling R&W o Servicing representations and warranties will transfer with the servicing – Enterprises retain all contractual rights and remedies for breach of servicing R&W o Enterprises will continue to leverage available tools to offset additional counterparty risk exposure and the bifurcation of selling and servicing R&W
TBA	The following will be implemented to address perceived concerns with prepayment churn: ▪ Net tangible benefit test o Net tangible benefit requirements will be imposed for streamlined refinances consistent with the net tangible benefit requirements for FHA streamline refinance transactions with the exception that a reduction in the amortization term of the mortgage will be considered a tangible benefit o Test parameters for determining net tangible benefits will be consistent among Enterprises ▪ Continued monitoring and tracking of prepayment speeds of each servicer o All seller/servicers, including aggregators, will be accountable for their prepayment speeds, regardless of the origination channel (retail, wholesale, or correspondent) o If the Enterprise determines that the seller/servicer's prepayment speeds are excessive, the Enterprise has the option to impose fees
Other Considerations	▪ The mortgage servicing right still exists; servicer of record will maintain direct customer relationship ▪ Monetizing all or part of the servicing structure will help provide cash flow to enhance the seller/servicer's liquidity

The diagram on the following page provides an illustrative depiction of the Fee for Service model options.

Potential Future Servicing Compensation Model - Illustrative Fee for Service

Borrower Note Rate	6.000%	
G-fee	0.200%	
Servicing Fee	X	
New Excess IO	0.25% - X	0.30%
Excess IO	0.050%	
MBS Coupon Rate	5.500%	

Total Mortgage Banking Economics for Origination & Servicing unchanged

- set by lenders at time of origination

- the lender's decision variable is how much total spread (MSF + Excess IO) to put into the borrower's note rate, which then gets reflected in the primary-secondary spread

- this is separate from the guarantor-determined g-fee to compensate for the credit risk

Current Servicing Compensation Model

Borrower Note Rate	6.000%	
G-fee	0.200%	
Minimum Servicing Fee	0.250%	0.30%
Excess IO	0.050%	
MBS Coupon Rate	5.500%	

	Potential Future: MSR	Potential Future: Excess IO – Option A: Status Quo	Potential Future: Excess IO – Option B: Standalone Excess IO for Seller/Servicer	Current: MSR	Current: Excess IO
Unit Of Account	MSR	IF Excess IO considered part of Servicer Compensation, then combined with MSR	IF Excess IO separated from Servicer Compensation, then Standalone IO	MSR	Considered part of MSR
Cashflows	Servicing Fee (X bps) OR $Z/loan [while PL] + NPL Incentive Payments (e.g., Servicing Alignment) + net Float and Ancillaries - Costs to Service	(25+5 - X) bps [while PL]		Servicing Fee (25bps) + NPL Incentive Payments (e.g., Servicing Alignment) + net Float and Ancillaries - Costs to Service	5bps [while PL]
Accounting Model	IF Excess IO considered part of Servicer Compensation, then include both Excess IO + MSR cashflows in overall Adequate Compensation Assessment		Investment in Retained Interest	Combined MSF & Excess IO Adequate Compensation Assessment	
Capitalized?	IF Excess IO considered part of Servicer Compensation, then most likely **capitalized if** both Excess IO + MSR cashflows similar to current model ELSE IF Excess IO is separated from Servicer Compensation, then more likely **not capitalized** once MSR cashflows not deemed to be paying above market-determined reasonable returns for a replacement servicer		Yes - at Fair Value	Yes - Combined at Fair Value Creates financial asset with economic, accounting & capital volatility; costly to hedge; impacts competitive factors	
Fair Value Approach	IF capitalized combined MSR+Excess IO asset, then both MSR and Excess IO fair valued same as today (Level 3 Asset) ELSE IF not capitalized MSR, then N/A		Yes - Level 2 Asset (leverage Trust IOs or Excess IOs valuations)	Level 3 Asset (less transparent, model driven)	
Collateral for R&W	Servicing R&W Bifurcated Seller R&W (if Excess IO separated)	IF Excess IO considered part of Servicer Compensation, similar restrictions as today's MSR	N/A - Excess IO will be the lender's asset (that can be freely sold or pledged as desired)	Seller R&W AND Servicing R&W (subject to guarantor approval for sale; lender restricted in ability to further pledge this MSR asset)	
Best Execution Options	MSR - Sell Servicing Released OR MSR - Servicing Retained to receive the servicing activities for a fee stream over time that does not result in a financial asset with economic, accounting and capital volatility with associated competitive factors	IF Excess IO considered part of Servicer Compensation, same best execution options and restrictions as in today's MSR	Retain previous Excess IO monetization options New monetization option to sell Excess IO at/after origination to wider set of investors (e.g., Wall Street, Other IO Investors, GSEs) Ability to retain the same IO exposure as in current model by retaining same total MSF + Excess IO (Tax safe harbor & required capital on Excess IO may impact economics; analysis suggests small borrower impact)	MSR - Sell Servicing Released OR MSR Servicing Retained AND monetize Excess IO (down to MSF) via MBS Coupon or BU/BD at Origination MSR Servicing Retained AND sell Excess-IO in SMBS after origination subject to Guarantor Approval	