December 23, 2011

Via Electronic Mail

Mr. Edward DeMarco
Acting Director
Federal Housing Finance Agency
1700 G Street, N.W., 4th Floor
Washington, D.C. 20552

RE: Alternative Mortgage Servicing Compensation Discussion Paper

Dear Mr. DeMarco:

The PNC Financial Services Group, Inc. ("PNC") appreciates the opportunity to submit comments to the Federal Housing Finance Agency ("FHFA") on its Alternative Mortgage Servicing Compensation Paper. The paper provides thoughtful and constructive alternatives to the existing servicing compensation structure for single family mortgage-backed securities guaranteed by the government sponsored enterprises ("GSEs") and we support FHFA's efforts to provide a way forward on this important issue.

PNC is a diversified financial services company with approximately $269 billion in assets, as of September 30, 2011. PNC businesses engage in retail banking, corporate and institutional banking, asset management, and residential mortgage banking. PNC Mortgage, a division of PNC, originates first-lien mortgage loans throughout the United States and PNC also originates home equity closed- and open-ended residential loans. PNC Mortgage is one of the top 10 retail residential mortgage originators and servicers with a mortgage servicing portfolio of approximately $121 billion, as of September 30, 2011. PNC's mortgage team serves our customers through 2,480 retail banking branches and our network of 185 retail mortgage offices in the continental United States.

PNC strongly supports key aspects of the comment letters on the paper filed by The Clearinghouse Association ("TCH") and the Mortgage Bankers Association ("MBA").[1] PNC believes that certain elements of the current structure of mortgage servicing should be changed. Under the existing servicing fee structure, there is insufficient revenue to offset servicing costs during times of extremely high levels of default, as has been experienced during the recent crisis and ensuing downturn in the housing finance market. Furthermore, mortgage servicing fees under the current structure may result in capital charges for mortgage servicing rights ("MSRs")

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[1] Letter to Mr. Edward DeMarco, Acting Director of FHFA, from Mark Zingale, Senior Vice President and Associate General Counsel of The Clearinghouse Association, dated November 7, 2011; Letter to Mr. Edward DeMarco, Acting Director of FHFA, from Debra W. Still, President and CEO of Pulte Mortgage LLC and David Stevens, President and CEO of the Mortgage Bankers Association, dated December 8, 2011.

under the impending Basel III risk-based capital regulations that could force institutions to reduce their ownership of MSRs. Thus, PNC supports FHFA's efforts to address these shortcomings.

At the same time, it is important to stress that there are hallmarks of the current system that should be preserved. A capitalized MSR aligns the interest of the servicer with both MBS investors and borrowers by ensuring the servicer has adequate "skin in the game." Moreover, a capitalized MSR asset provides a powerful incentive for quality servicing by giving the guarantor the ability to seize the asset in the event of servicer nonperformance. This prevents servicers from engaging in adverse selection and churning.

PNC believes the shortcomings of the current compensation structure for MSRs can be addressed by taking an approach that is close to Option 1 as outlined in the paper. Specifically, we believe that—

- The current model for "normal servicing fees" (i.e., servicing fees for times when loan defaults are not exceeding reasonable expectations and forecasts) should be similar to the Ginnie Mae model so that servicers can charge a servicing fee of 25 bps, but also have the option of taking a reduced fee as low as 12.5 bps; and
- A separate custodial reserve account should be established and funded at 3–5 bps to support unanticipated market conditions that significantly increase the costs of servicing loans in default.

These changes would reduce volatility of MSRs, address concerns about impending capital charges on MSRs and create a structure that ensures that funds are available to be used for increased servicing expenses during times of unanticipated high levels of default.

PNC does <u>not</u> support the "fee for service" approach outlined in Option 2 of the paper. This approach would perpetuate too large a role for the GSEs in the mortgage market, provide disincentives for quality servicing, and introduce significant counter-party risk to servicers and investors. We also add our voice to the joint trade association letter signed by TCH, MBA, the Securities Industry and Financial Markets Association, the Housing Policy Council, and the Community Mortgage Banking Project indicating that a fee for service model could have severe negative consequences.[2] This letter also stresses that FHFA should not pursue this option unless it can demonstrate strong and compelling evidence that a fee-for-service structure would be in the long-term interests of the mortgage market and the consumers that it serves.

A. **<u>Reducing Minimum Servicing Fee</u>.**

A reduced minimum servicing fee will provide significant capital relief to banking organizations that will be required to comply with the upcoming Basel III risk-based capital standards while

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[2] Letter to Mr. Edward DeMarco, Acting Director of FHFA, from Mark Zingale, Senior Vice President and Associate General Counsel, The Clearinghouse Association, Glen Corso, Managing Director, Community Mortgage Banking Project, Paul M. Leonard, Senior Vice President, Housing Policy Counsel, Stephen A. O'Connor, Senior Vice President, Public Policy and Industry Relations, Mortgage Bankers Association, and Richard A. Dorfman, Managing Director, Head of Securitization, Securities Industry and Financial Markets Association, dated December 22, 2011 ("Joint Trades Letter").

preserving the MSR asset and the various benefits it provides to its holders.[3] We note that concerns about the capital charges associated with MSRs will apply to not only large banking organizations, but any banking organization that will be subject to the heightened capital standards. PNC believes that an appropriate floor for the fee for servicing loans in MBS that are experiencing expected levels of default would be 12.5 bps, i.e., a 50 percent reduction in the current 25 bps amount.

We also believe that it is of paramount importance to preserve the benefit of the current IRS tax safe harbor relating to MSRs,[4] which allows the deferral of tax payments for normal servicing rights. This is an issue of great importance for small- and medium-sized loan servicers and PNC supports preservation of the safe harbor to ensure wide participation in the mortgage servicing business in the private sector. Thus, we urge FHFA to retain the current "normal servicing fee" of 25 bps, consistent with the IRS tax safe harbor, and allow servicers to charge lower fees down to 12.5 bps.

B. **Reserve Account.**

PNC supports TCH's proposal for the creation of a custodial reserve account that would be used to cover increased servicing expenses due to unanticipated increases in nonperforming loans. Funding of the reserve account—essentially, a "crisis scenario default servicing reserve"—would be accomplished through the mortgage cash flow and retained in a bankruptcy remote vehicle for the benefit of the servicer. The reserve account would be tied to specific vintages of loans. Unused portions of the reserve account would be returned to the servicer if loan performance in the securitization is within an expected range after four years. If the performance has deteriorated beyond that range, the reserve account would continue to be funded. The reserve account and rights to the unused portion of the reserve account would travel with the servicing of the pool. PNC believes that a crisis scenario default servicing reserve of 3-5 bps would be sufficient to cover the unanticipated expenses.

The reserve account would help to address many of the shortcomings of the existing compensation structure that have come to light in the recent crisis. As TCH indicated in its letter, the reserve account would:

- Ensure that funds are available to meet unanticipated servicing costs;
- Ensure that servicers make the necessary investment to cover the potential costs of servicing large volumes of non-performing loans;

[3] Under the Basel III Accord, the amount of MSRs that can be counted as Tier 1 capital is capped at 10 percent. In addition, a banking organization 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 percent and 15 percent thresholds are expected to be phased in over a period of years.

[4] In 1991, the Internal Revenue Service issued Revenue Ruling 91-46, which provides, among other things, a safe harbor for "normal servicing rights" so that payment for these rights is treated as compensation for future services. Therefore, capitalizing normal MSRs are not currently taxable. The current MSR compensation of 25 bps typically qualifies for this IRS tax safe harbor.

- Ensure that funds set aside for unanticipated servicing costs are protected, regardless of what happens to either the servicers or the GSEs;
- Create an incentive for quality and proactive servicing by rewarding servicers for good performance and by imposing discipline on servicers to continue to cover the expected costs of non-performing loans within their normal operations; and
- Facilitate the transfer of servicing for cause by having the reserve follow the servicing contract.

In addition, we believe that consumers will ultimately benefit from the servicer's increased ability to respond to unanticipated market events and successfully navigate the credit cycle, however severe.

PNC analyzed historical mortgage data from CoreLogic to assess whether default servicing reserve of 3-5 bps would cover actual servicing costs of nonperforming loans over a 10-year timeframe. Based on this analysis, a crisis default servicing reserve of 3-5 bps would cover the incremental cost of default servicing in times of extreme distress. As FHFA proceeds with this proposal, we urge it to study carefully the appropriate level for the default servicing reserve using data from the recent crisis to assess what the appropriate amount should be.

We also believe that the tax and accounting treatment of the reserve account should be studied carefully. While the tax and accounting treatment of the reserve account is obviously important, it should not be seen as a "make or break" issue that determines either the feasibility or the desirability of Option 1.

C. **Fee for Service Option.**

PNC endorses the views expressed in the TCH, MBA and Joint Trades letters that the fee for service model outlined in Option 2 of the paper could have detrimental effects on the quality of servicing and the ultimate cost of mortgage credit to the consumer. We are unaware of any other mortgage industry trade association that would endorse a fee for service approach to address the concerns about the current mortgage servicing model.

As we understand Option 2, the GSEs, as master servicer, could receive 8 bps of outstanding principal per annum and pay out to the servicer $10 per loan per month. The GSEs would control the servicing rights and have discretion to revise up or down the price they pay for servicing. This proposal would give the GSEs revenue sources that they do not have currently and would accentuate their role in the market. Since the future of the GSEs is a fundamental policy decision that needs to be answered in order for the private securitization market to be fully functional, we do not believe proposals that could perpetuate the GSEs should be pursued. Furthermore, the MBA points out in its letter that the breakeven average principal balance for the GSEs under the fee for service model outline in Option 2 is $150,000. We are concerned that the GSEs would have pressure to lower servicing fees for loans with amounts below that principal amount. That will result in lower quality servicing for these loans.

In our view, a fee for service model would—

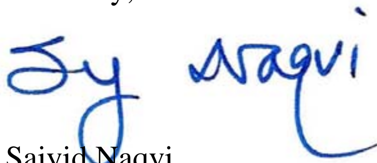
- Discourage investment in the infrastructure required to service both performing and non-performing loans;

- Reduce incentives for high quality servicing for non-routine activities, such as early stage forbearance and loss mitigation, by reducing compensation on performing loans and increasing it on non-performing loans.
- Eliminate servicer “skin-in-the-game” and raise investor concerns over “churning”;
- Disadvantage smaller servicers who would be unable to capture economies of scale.

For these reasons, we urge FHFA to abandon its pursuit of a fee for service model and instead pursue a form of Option 1 as outlined above.

Thank you for your consideration of these comments. If you would like to discuss any aspect of this letter, please do not hesitate to contact me.

Sincerely,



Saiyid Naqvi
CEO
PNC Mortgage