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Sent: Tuesday, November 22, 2011 3:24 PM
To: #Servicing Compensation
Subject: TCH Response to FHFA Discussion Paper on Servicing-Compensation Reform

On behalf of The Clearing House Association, I attach a copy of TCH's response to the FHFA discussion paper. The attached document was also emailed to Ed DeMarco.

We would welcome the opportunity to meet and further discuss with the FHFA the issue of servicing-compensation reform and our specific responses.

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November 7, 2011

Via Electronic Delivery

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

Dear Mr. DeMarco:

The Clearing House Association¹ is writing this letter in response to the FHFA's recent discussion paper on servicing compensation reform.² The paper provides a thoughtful analysis of two alternative approaches that could be used to improve the compensation structure that exists today. Option 1 would reduce the minimum servicing fee ("MSF") and create a separate custodial reserve account to cover unanticipated increases in servicing costs. We supported this approach in our May meeting with the FHFA, Ginnie Mae and the government-sponsored enterprises ("GSEs"), and we are grateful that it was included in the report.³ Option 2 would involve a more fundamental change and replace the current compensation structure with a fee-for-service approach.

We recognize that there are many interested parties who have a stake in servicing compensation reform and that it is difficult to weigh their sometimes-conflicting interests. We

¹ Established in 1853, The Clearing House is the oldest banking association and payments company in the United States. It is owned by the world's largest commercial banks, which collectively employ over 2 million people and hold more than half of all U.S. deposits. The Clearing House Association L.L.C. is a nonpartisan advocacy organization representing—through regulatory comment letters, amicus briefs and white papers—the interests of its owner banks on a variety of systemically important banking issues. Its affiliate, The Clearing House Payments Company L.L.C., provides payment, clearing, and settlement services to its member banks and other financial institutions, clearing almost \$2 trillion daily and representing nearly half of the automated-clearing-house, funds-transfer, and check-image payments made in the U.S. See The Clearing House's web page at www.theclearinghouse.org.

² "Alternative Mortgage Servicing Compensation Discussion Paper," Federal Housing Finance Agency, September 27, 2011.

³ The TCH presentation can be found at <http://www.theclearinghouse.org/index.html?f=072887>.

also recognize that the FHFA has established a number of different objectives that it hopes to achieve through its Joint Servicing Compensation Initiative and that neither alternative is clearly superior when judged against each of these different yardsticks. With these caveats in mind, however, we would like to take this opportunity to reiterate our reasons for supporting Option 1, present our views on the strengths and weaknesses of Option 2, and address some of the specific questions that were raised in its report.

The FHFA has added a number of important provisions to Option 2 that address potential shortcomings in a fee-for-service model. However, after careful consideration of the specific proposal, we continue to believe that the weaknesses inherent in Option 2 outweigh the potential benefits. We also continue to believe that the structure proposed under Option 1 will do a reasonable job in meeting the FHFA's stated objectives and that it will ultimately serve the interests of consumers. The various considerations that have caused us to reach these broad conclusions are presented in our comments below.

1.0 Option 1

Our recommended approach to servicing compensation reform has two key elements: (1) a material reduction in the minimum servicing fee and (2) a separate custodial reserve account to support unanticipated market or regulatory changes that significantly increase the costs of servicing loans in default. In our view this two-pronged approach to servicing-compensation reform will address some of the more troubling aspects of the current structure, while at the same time preserve certain features that have served the market extremely well for decades.

1.1 Material Reduction in the MSF

Mortgage-servicing rights ("**MSRs**") are complex financial instruments that are admittedly capital intensive, complex to hedge and difficult to value, and their management has little, if anything, to do with the core competencies expected of mortgage servicers. Impending Basel III capital rules will only make a difficult situation even worse, especially for financial institutions that hold a significant share of their assets in servicing rights. This is not just a "big bank issue." Any bank that devotes a relatively large share of its assets to the origination and servicing of residential mortgages will be affected by the change.

At the same time, however, the presence of a capitalized MSR asset provides significant "skin in the game" that helps to align the interests of the servicer with the interests of the GSEs, Mortgage-Backed Securities ("**MBS**") investors and borrowers. In particular, the MSR asset:

- provides a powerful incentive for quality servicing by giving the guarantor the ability to seize the asset in the event of servicer non-performance;

- makes it easier to transfer servicing rights for cause by tying the MSR asset to the servicing of the loans; and
- reduces incentives for adverse selection and “churning” by giving servicers significant skin in the game, thereby aligning the servicer’s incentives with those of the MBS investor.

For these and other reasons, changes to the existing compensation structure should be done with care.

Although the various trade-offs associated with a change to the MSF are complex, reducing the MSF to a level that does not require capitalization or eliminating it altogether would, in our opinion, be ill-advised. Such a structure would threaten the general alignment in interests that now exists among the various parties involved in the servicing contract. In addition, for many smaller servicers, the resulting cash flow would not be enough to support the high fixed costs that are associated with the servicing of both performing and non-performing loans. While smaller servicers can always choose to retain a higher portion of the strip, there is no guarantee that they will do so. In this sense, establishing a minimum servicing fee provides additional protection to the guarantor, the investor and the borrower by ensuring that servicers have the cash flow required to cover their costs and adequately service the loans.

At the same time, we do not believe that retaining the status quo in light of the impending Basel III regulations is an attractive option either. A high MSF continues to be a significant barrier to entry for many smaller servicers and will only get worse by the anticipated increase in capital requirements. In addition, institutions with high concentrations of servicing assets may be forced to reduce their existing MSR holdings and most likely curtail their reliance on correspondent lending channels. The net result could be an unnecessary turnover in servicing contracts, the dislocation of small originators, and higher mortgage rates.

We do not support either extreme. Rather, we believe there is a middle-ground approach that would provide significant capital relief while preserving the MSR asset and the various benefits that it conveys. Accordingly, we have proposed cutting the MSF in half (i.e., to 12.5 basis points (“**bps**”)) as a reasonable starting point to achieve both ends. While greater precision could be brought to bear, for ease of implementation, a minimum fee of 12.5 bps—or 1/8th—has the advantage of consistency with the way MBS are traded. We would welcome the opportunity to explore this issue in greater detail with the FHFA, the GSEs, investors, and other interested parties.

1.2 The Establishment of a Custodial Reserve Account

The second major element of our proposal is the creation of a custodial reserve account, the details of which were presented in our June 10th letter to the FHFA.⁴ Under our proposed approach, roughly 3 bps from the mortgage cash flow would be retained by the mortgage servicer and used to create a refundable custodial reserve account designed to cover unanticipated increases in either the costs or incidence of nonperforming loans (“NPLs”). The reserve account would be tied to a specific vintage of loans 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. The terms for both accessing and releasing the reserve funds would be established in advance as part of the servicing contract.

We believe that the creation of 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. The reserve fund would:

- ensure that the necessary funds are available to meet unanticipated servicing costs over various stages of the credit cycle;
- ensure that servicers make the necessary investment to cover the potential costs of servicing large volumes of non-performing loans;
- ensure that the funds are protected, regardless of what happens to either the servicers or the GSEs;
- create an incentive for quality servicing by rewarding servicers for good performance and by requiring that servicers 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 the end, 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.

Some have linked the viability of our proposed approach to the ultimate tax and accounting treatment of the reserve. Both are admittedly uncertain at this point in time and could conceivably differ across institutions. While there is general agreement that the reserve

⁴ See <http://www.theclearinghouse.org/index.html?f=072886>.

account will have to be capitalized, there is less agreement on whether or not the reserve will be treated as part of the MSR. However, combined with the proposed reduction in the minimum servicing fee, our approach will result in significant capital relief *regardless of how the 3 bps strip is ultimately treated*. As a result, 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 our proposed approach.

2.0 Fee-for-Service Compensation Structure

A fee-for-service approach has some advantages over the current compensation structure.⁵ In particular, it would:

- eliminate the MSR and the associated capital requirements;
- reduce the complexity of servicing and allow servicers to focus on core competencies; and
- reduce any existing bias against smaller loans.

However, in our view these benefits are largely overshadowed by the adverse impact that such a compensation structure could have on the quality of servicing and the ultimate cost of mortgage credit to the consumer.

Some of our specific concerns follow.

- ***A fee-for-service approach would exaggerate, and not reduce, the drive to become the low-cost service provider by providing the minimal level of service.*** One of the acknowledged shortcomings of the existing servicing industry is its failure to invest in the necessary infrastructure to handle the large volume of non-performing loans that followed in the wake of the housing crisis. Replacing a servicing asset (i.e., the MSR) with a “pay as you go” compensation structure will only make this tendency more pronounced for both performing and non-performing loans. In the end, failure to invest in the necessary infrastructure will adversely affect the quality of service that is delivered to the borrower, who depends on the mortgage servicer to receive, record and disburse a large portion of his or her monthly income in a manner that is consistently accurate, reliable and timely.
- ***Moving towards a dollar-per-loan compensation structure could also threaten to disrupt the “life of loan” relationship that servicers currently have with the borrower.*** There is

⁵ Our comments focus on the FHFA’s proposal to reduce the servicing fee to \$10 per loan. However, most of our comments also apply to a smaller strip (e.g., 3 to 6 bps) that does not require capitalization (the other alternative suggested by the FHFA).

nothing in the construct of a fee-for-service approach that would prevent the servicing contract from being renegotiated on a regular basis and awarded based on cost. While this might be beneficial to the GSEs, it is doubtful that such a system would benefit consumers, who would inevitably find frequent transfers of servicing confusing, frustrating and susceptible to error. Frequent transfers of servicing would also further reduce the servicer's incentives to invest in the necessary infrastructure and provide more than the minimal level of service.

- ***Having Fannie Mae and Freddie Mac control the funds that are used to cover servicing costs would expose servicers—and ultimately borrowers—to significant counterparty risk and conflict with broader policy objectives.*** Switching the responsibility for covering the ordinary and extraordinary costs of mortgage servicing from the servicer to the guarantor does nothing to change the underlying nature of the MSR asset, but merely transfers it to the GSEs. This switch is problematic for several reasons. To begin with, reserves that are created to manage the future servicing obligations of the GSEs would be part of their balance sheets and might not survive any future restructuring of the enterprises. Jeopardizing the reserves in any way could leave many servicers without the resources required to fulfill their obligations to the borrower and lead to a general breakdown in the servicing function. In addition, since servicing fees would be adjusted on a regular basis by the GSEs—without any guarantee that they would be sufficient to cover the servicer's costs—uncertainty regarding the adequacy of future compensation could further undermine the servicer's incentives to make ongoing investments in the necessary infrastructure. Finally, having Fannie Mae and Freddie Mac control and manage a large portfolio of servicing assets is inconsistent with the broader public policy objective of reducing the size of their investment portfolios and their ongoing issuance of debt.
- ***Eliminating the MSR asset would reduce the guarantor's leverage over the servicer in the event of non-performance and make it more difficult to transfer servicing rights.*** The resulting decline in the GSEs' ability to manage their credit risk would expose them to higher losses. The elimination of the MSR asset and reduction in guarantor leverage would also hinder the GSE's ability to ensure that troubled borrowers receive the additional loss-mitigation services that they may need to remain in their homes or, if not, avoid foreclosure.
- ***Eliminating the servicer's "skin in the game" could increase incentives for churning and heighten investors' concerns over prepayment risk.*** The To-Be-Announced ("TBA") market would inevitably price for this risk, leading to higher mortgage rates. While the FHFA has proposed a number of requirements that could help to mitigate these effects—including a

net-tangible-benefit test for streamlined refinances and a cap on the amount of excess interest-only (“IO”) strip that could be included in any pool—the impact of these provisions is uncertain and would probably not be enough to off-set the likely impact on interest rates.

- ***A \$10-per-performing-loan compensation structure is unlikely to cover the high fixed costs associated with the servicing of both performing and non-performing loans, particularly for smaller servicers.*** As a result, such a structure could actually increase barriers to entry for smaller lenders who are unable to benefit from large economies of scale. While elimination of the MSR may well pave the way for large technology and data-processing firms, it is not at all clear that the entry of such firms at the expense of smaller banks is in the interests of consumers.
- ***A \$10-per-performing-loan compensation structure fails to address the high costs of servicing delinquent loans, including borrower counseling and other loss-mitigation activities.*** Although the FHFA proposal allows for a continuation of incentive payments for standard NPL activities and outcomes, it is silent on what, if any, additional resources would be made available for the servicing of non-performing loans, particularly in the event of a severe housing downturn. As a result, in contrast to our proposed approach, it does nothing to address what we see as one of the core weakness of the current compensation system: its inability to cover costs over various stages of the credit cycle.

For all of these reasons, we continue to believe that Option 1 is the better way to go.

3.0 Response to FHFA Questions

The remainder of this letter addresses some of the questions that FHFA raised in its discussion paper.

Question 1: What are the impacts of these proposals on the competitive landscape in origination and servicing markets, service to borrowers, and efficiencies in secondary markets?

- ***Market Impact.*** The mortgage origination and servicing industries today are highly concentrated and have become more so in recent years. The reasons for these trends are varied and complex, ranging from an increasingly demanding regulatory environment to the large economies of scale that are associated with both the origination and servicing of loans.

Changing the nature of the servicing contract could conceivably impact the structure of the servicing industry, although the results are by no means certain. For example, reducing or

eliminating the MSR asset would reduce the complexity and capital costs associated with the servicing function, potentially making it easier for smaller, more capital-constrained banks to retain their servicing rights and for non-banks to enter the market. However, such a change would not affect the large economies of scale that are associated with the servicing of loans. Although barriers to entry could be reduced for large technology and data processing companies that are able to capture scale economies, this would most likely occur at the expense of smaller banks.

Likewise, the impact of simply maintaining the status quo in face of impending Basel III regulations is unclear. Absent any change, banks that hold a relatively large portion of their assets in servicing rights may be forced to off-load some of these assets, creating a potential opportunity for less efficient servicers to enter the market or to increase their market shares. At the same time, however, institutions attempting to reduce their holdings of MSRs would most likely reduce or eliminate their reliance on correspondent channels, which would have a negative impact on small originators. These potentially offsetting impacts make the net effect on industry structure difficult, if not, impossible to predict.

Even if one could predict the impact of any change on industry structure, it is by no means certain that the net result would be beneficial to consumers. For example, replacing an efficient service provider with a less efficient one might reduce the level of concentration but ultimately increase costs or reduce the quality of service to the borrower. Nor is it obvious that replacing a small community bank with a large technology company is an optimal outcome from the consumer's perspective.

The net result is that it is difficult to make the case either that a change in the compensation structure will have a significant impact on industry structure or that any change in industry structure that does occur will necessarily have a positive impact on consumers.

Service to Borrowers. As already noted in our comments on Option 2, we believe that a fee-for-service approach will ultimately reduce the quality of services that are delivered to the borrower by:

- increasing the servicer's incentives to compete on the basis of price by delivering a minimal level of service and under-investing in the necessary infrastructure;
- reducing the servicer's skin in the game, potentially leading to increased churning, a reduction in investor demand for MBS and higher mortgage rates;
- reducing the GSE's ability to transfer servicing rights in the event of servicer non-performance, which could result in borrowers receiving substandard service just when they need it most;

- exposing consumers to the risk that funds that would otherwise be used to support the servicing of their mortgages would be inadequate or disappear altogether with the eventual restructuring of the GSEs.

Our proposal attempts to mitigate these effects by reducing, but not eliminating, the MSR asset and by establishing a bankruptcy-remote reserve that would survive the demise of either the servicer or the GSE. The reserve account, in particular, is designed to guard against a recurrence of some of the problems that the industry faced with the onset of the recent housing downturn. By ensuring that the necessary funds will be available to support unanticipated market events or policy demands, the reserve account should help to ensure that funds are available to support the servicing of loans over different stages of the housing and credit cycles.

- **Efficiency in Secondary Markets.** The TBA market is one of the largest, most efficient markets in the world. It would undoubtedly adjust to either compensation structure that the FHFA has suggested. That is not to say, however, that the impact of the two alternatives would be the same. As we have already noted in our comments on Option 2, we believe that a fee-for-service model would inevitably raise investor concerns over potential churning and adverse selection and that the market would price for such concerns. At the same time, we recognize that our proposal to significantly reduce the MSR asset could have a similar, albeit smaller, effect on investor expectations. However, we believe that our approach, which preserves the basic structure of the current model, would be more readily accepted in the market, as evidenced by the favorable trading of Ginnie Mae IIs.

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

As a trade association, we are not in a position to comment on the impact of an MSR asset on any particular company's business model, although some of our members may choose to respond on an individual basis. However, we note that we have already presented our thoughts on the pros and cons of a capitalized MSR asset in our discussion above.

Question 3: Should a lender's excess IO remain contractually attached to the MSR, or would the seller/servicer prefer to have the excess IO be a separate stand alone asset?

From the perspective of the seller/servicer, treating the excess IO as a separate, stand-alone asset would be desirable since it would provide greater flexibility in execution, and flexibility is generally viewed in a positive light. However, we would not recommend this provision in combination with a fee-for-service approach.

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

As previously stated, we believe that Option 2 will reduce, as opposed to strengthen, the servicer's incentives to invest in the infrastructure required to service both performing and non-performing loans. In contrast, the creation of a reserve account should help to ensure that the necessary funds will be available to the servicer in the event of a severe market downturn. While it may be difficult to avoid all of the operational issues that would be associated with a rapid ramp-up in NPL operations, the presence of an adequately funded reserve account should help to smooth the transition process.

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

The TBA is a large and liquid market that would inevitably adjust to Option 2. However, the elimination of a capitalized MSR asset would most likely increase investor concerns over the potential for churning and adverse selection. While such market expectations can undoubtedly be priced and absorbed, they would most likely lead to higher mortgage rates for the consumer.

Question 6: Should any of the following provisions that were included in the fee-for-service proposal be considered independent of any other changes to the servicing contract?

- ***Bifurcation of selling and servicing representations and warranties.*** The bifurcation of seller reps and warrants would make it easier to buy and sell servicing rights, thereby increasing the liquidity of the servicing asset. It would also facilitate the transfer of servicing for cause. If used judiciously, both outcomes would be desirable.
- ***Net tangible benefits test for streamlined refinances.*** A net-tangible-benefits test for streamlined refinances could help to mitigate investor concerns over potential "churning" and lead to better pricing in the TBA market. While the potential magnitude of such an effect is uncertain—and probably relatively small—the option is worth exploring. However, it is unclear whether the GSEs are in the best position to establish the test or to monitor servicers for compliance.
- ***Restrictions of the amount of excess IO in a given pool.*** Limiting the amount of excess IO present in any pool helps to mitigate incentives for adverse selection. In fact, these kinds of restrictions are already in place in the GSEs' general pooling parameters.
- ***Limitation of P&I advance requirements.*** Limiting P&I advance requirements would facilitate market entry by less-liquid, more-capital-constrained entities and at the same

require the GSEs to increase their issuance of short-term debt. It is not at all clear whether these outcomes would be beneficial to the market as a whole or to consumers.

- ***Flexibility of excess IO execution.*** Our members would clearly view increased flexibility of excess-IO execution, either under the current compensation structure or under The Clearing House's proposed approach, as a positive outcome.

* * * * *

In summary, it is our view that a fee-for-service model would merely move revenue and costs from servicers to the GSEs without adequately addressing the underlying issues associated with MSRs—and at the risk of doing more harm than good. Taking such an approach could disrupt the general alignment of interests that now exists between the various parties involved in the servicing of loans and increase—not reduce—the servicer's incentives to become the low-cost provider by providing the minimum level of service. And while a fee-for-service approach might encourage the entry of large technology firms, it would probably do so at the expense of smaller servicers, who could find a \$10-per-loan compensation structure insufficient to cover the high fixed costs of servicing loans.

Given the challenges and uncertainties associated with Option 2, we believe that the best way forward is a middle-ground approach that would provide capital relief while preserving the MSR asset—and all the incentives and relationships it represents. Cutting the existing MSF in half would support new entrants, thereby reducing concentration, while preserving enough of the asset to ensure that service levels remain intact. In times of strain, the creation of a custodial reserve account would ensure that funds are readily available. Option 1 could be enhanced by bifurcating seller reps and warrants and including a net-tangible-benefits test for streamlined refinances.

Thank you for the opportunity to share our thoughts on various ways to improve the compensation structure for mortgage servicers. If you have any questions or would like to discuss these or other issues in more detail, please feel free to contact me at 212-613-9812 or Mark.Zingale@theclearinghouseassociation.org.

Sincerely,



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The Clearing House Mortgage Lending Reform Committee

The Clearing House Bank Regulatory Committee

The Clearing House Government and Legislative Affairs Committee