



December 8, 2011

Mr. Edward DeMarco
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Submission to: Servicing_Comp_Public_Comments@FHFA.gov

Re: *Alternative Mortgage Servicing Compensation Discussion Paper*

Dear Mr. DeMarco:

The Mortgage Bankers Association¹ appreciates the opportunity to comment on FHFA's *Alternative Mortgage Servicing Compensation Discussion Paper* (Discussion Paper). Below please find MBA's general comments on the Discussion Paper, our answers to the specific questions for public comment, a draft term sheet for the cash reserve method, and an update of "The Good, the Bad and the Ugly Analysis" from the original letter sent by MBA to FHFA in June.

Background Information

In February 2011, FHFA released a document that illustrated four servicing fee structures that the FHFA, Fannie Mae, Freddie Mac and Ginnie Mae (Guarantors) were exploring. The first structure presented was what the industry has dubbed the "Alternative Minimum Servicing Fee" or "AMSF." Rather than take a fee based upon an interest strip, the servicer would take an unguaranteed interest in both the principal and the interest cash flows. In the February document that fee was assumed to be a 1 percent interest in principal and interest cash flows. The other three structures in the

¹ The Mortgage Bankers Association (MBA) is the national association representing the real estate finance industry, an industry that employs more than 280,000 people in virtually every community in the country. Headquartered in Washington, D.C., the association works to ensure the continued strength of the nation's residential and commercial real estate markets; to expand homeownership and extend access to affordable housing to all Americans. MBA promotes fair and ethical lending practices and fosters professional excellence among real estate finance employees through a wide range of educational programs and a variety of publications. Its membership of over 2,200 companies includes all elements of real estate finance: mortgage companies, mortgage brokers, commercial banks, thrifts, REITs, Wall Street conduits, life insurance companies and others in the mortgage lending field. For additional information, visit MBA's Web site: www.mortgagebankers.org.

February document were various permutations of the existing fee structure. The first assumed a minimum servicing fee of 12.5 bps, the second assumed a minimum of 3 bps, and the final assumed no minimum servicing fee. In each of the proposed alternatives, the compensation relates to the servicing of performing loans. The guarantor would pay the servicer or special servicer additional fees for each non-performing loan on the basis of a flat dollar amount per loan, per month, based upon stage of delinquency.

During the succeeding months, FHFA met with various interested parties, including several meetings with MBA. In addition, MBA and the Clearing House Group separately proposed that the FHFA study and evaluate similar alternative structures which calls for deferring part of the existing servicing fee as cash reserve to cover servicing costs for catastrophic economic and default situations. On September 27, 2011, FHFA issued a Discussion Paper that requests comments on the aforementioned cash reserve structure and a structure that calls for payment for servicing performing loans of \$10 per loan per month and existing incentive payments for non-performing loans (NPLs). The FHFA currently favors this fee for service model.

MBA's General Comments

Over-Arching Comments

First, the majority of MBA's members believe that the existing servicing fee structure has served the market well for decades and is still viable. If FHFA believes that change is needed, it should look for a fee structure that is not a radical departure from today's structure. MBA believes that the proposed cash reserve structure would introduce changes that would better meet FHFA's stated objectives for the project and be less disruptive to the markets.

Second, MBA further believes that discussions with respect to changing servicing fee structure are pre-mature:

- Fannie Mae and Freddie Mac are in the process of putting in place a standardized servicer guide. In addition, consumer groups, regulators, state attorneys general and others are calling for more robust servicing requirements. MBA is on record as favoring the development of a national servicing standard. MBA therefore believes that it makes more sense for those standards, which will set the scope of the servicer's future work, to be finalized before future servicer compensation issues are addressed.
- During the early part of the recent economic crisis, the U.S. Treasury was the only market for Fannie Mae and Freddie Mac MBS, outside of a handful of mortgage REITs. The market for Fannie Mae and Freddie Mac MBS is more liquid now, but it still is fragile. Radical changes in any of the major structures underlying the existing TBA could reduce liquidity in the TBA.

Third, MBA notes that servicers come in a broad range of size and cost to service structures. A large and highly automated servicer can generally service loans at a cost significantly lower than a smaller servicer. Accordingly, if the FHFA decides to implement the cash reserve fee structure, the Guide should define “normal servicing” as a “reasonable range of 12.5 bps to 20 bps plus the bps of principal placed in a cash reserve for catastrophic NPL servicing.” This would provide a range of fees that fits large and small servicers and could result in fewer barriers to entry for new entrants into the servicing market. This recommendation needs to be vetted with SIFMA on the potential impact on the Government Sponsored Enterprise (GSE) TBAs and subject to – SIFMA’s alignment with this reasonable range concept.

Preface to Remaining General Comments

The following general comments start with MBA’s analysis of whether the proposed fee for service structure would accomplish FHFA’s stated objectives for the project. Next, MBA’s general comments turn to whether the fee for service structure would accomplish the Obama administration’s objective of reducing the government’s role in the future of housing finance. Then, MBA’s general comments review some of the process concerns with respect to FHFA’s servicer compensation project. Following that analysis is MBA’s observations on the impact of the proposed fee for service structure on the borrower, the investor, the GSE’s, the competitive landscape, and finally the servicer.

Would the Proposed Fee for Service Structure Accomplish FHFA’s Stated Objectives for the Project?

Improve Service to Borrowers? The proposal as stated in the Discussion Paper would be to compensate servicers at \$10 per loan per month over the life of the loan for performing loans and no compensation for NPLs other than existing incentive compensation. This would represent a net decrease in overall servicer compensation. MBA believes that such low levels of compensation may be insufficient for large and small servicers to continue to invest long term in facilities, systems and infrastructure to serve the borrower better. Further, existing incentive compensation programs do not necessarily focus on the most important areas like 30- and 60-day delinquent loan servicing.

In addition, as per the discussion below, MBA believes that the proposed fee for service structure coupled with expected increases in G-fees will ultimately increase prices borrowers pay to finance their homes.

MBA concludes that the proposed fee for service structure will not accomplish FHFA’s stated objective of improving service to borrowers.

Reduce Financial Risk to Servicers? The report card with respect to this objective is mixed. First, the proposed fee for service structure would result in less compensation to

the servicer over time but more cash flow up front. This would reduce the amount of mortgage servicing rights (MSRs) capitalized on the servicer's balance sheet and result in less income volatility and hedge costs associated with MSRs. However, the servicer would be locking in a flat monthly fee per loan for up to 30 years giving rise to inflation risk. Changes to that fee structure could be made unilaterally by the GSEs further exposing the servicer to financial risk. Likewise, the fee structure does not call for cash reserves or additional payments for servicer costs related to catastrophic economic, delinquency and foreclosure events. In addition, the fee for service structure would expose the servicer to a potentially significant new risk. Presently, servicers are paid out of the principal and interest payments from the borrowers. Under the proposed structure, the servicer's compensation would be paid by the GSEs. Given the fact that the GSEs are now in conservatorship and their future fate is not known, this gives rise to a significant counterparty risk to the servicer.

Overall, MBA concludes that the fee for service structure would reduce prepayment risk and hedging costs of MSR assets but expose the servicer to additional, significant financial risks that are beyond the servicer's control.

Provide Flexibility to Guarantors to Better Manage Non-performing Loans? MBA had a difficult time identifying possible ways in which the proposed fee for service structure would help the GSEs better manage NPLs. One possible form of additional flexibility is that the bifurcation of seller reps and warranties from servicer reps and warranties would make it easier to find a successor servicer, if needed. MBA points out that the bifurcation concept could be applied to the cash reserve fee structure as well, and the cash reserve would serve as an added incentive to a successor servicer.

A second possible form of flexibility of the proposed fee for service structure is that the guarantor could move servicing with less financial impact to the servicer. However, the other side of that coin is that the only servicing compensation available to the GSEs to pay a successor servicer would be the 8 bps the GSEs would receive to pay the successor servicer \$10 per loan per month. This may be inadequate especially if the servicing portfolio was not properly serviced in the past or has a high level of NPLs.

A third possibility is that the proposed compensation structure may be so unattractive to seller/servicers that private equity comes into the market to replace the volume of loans historically sold or securitized through the GSEs. If this is what the FHFA intends, one unintended consequence may be significant dislocation in the real estate finance market as volumes eventually flow from the GSEs to a still dormant private market. MBA believes that this may hinder the long-term recovery of the real estate and real estate finance markets.

If the GSE's intention relates to having the ability to move portions of a servicer's portfolio, instead of the existing "all or none", there are a number of solutions that could be constructed under any of the fee structures.

Promote Continued Liquidity for TBA for GSE MBS? MBA notes that one of the key factors in TBA liquidity is that the servicer must have a certain level of “skin in the game” to provide a negative economic incentive to refinance or “churn” the portfolio. The fee for service proposal will reduce servicer skin in the game to an immaterial amount, giving rise to serious ongoing TBA liquidity issues.

MBA also has a concern that the fee for service structure could particularly have an adverse impact on the liquidity of the Freddie Mac TBA. Freddie Mac securities are already trading behind Fannie Mae securities. If the fee for service fee structure is implemented, it will split the Freddie Mac liquidity into old vs. new securities. MBA believes that healthy competition between the GSEs is good for the market.

Would the Proposed Fee Structure Be Consistent With the Administration’s Objective of Reducing the Government’s Role In Real Estate Finance?

In February 2011, the Obama administration released a report to Congress, *Reforming America’s Housing Finance Market*. The report laid out the Administration’s plan to reform America’s housing finance market to better serve families and function more safely in a world that has changed dramatically since its original pillars were established nearly eighty years ago. Under the plan the private markets would be the primary source of real estate finance, and a stated goal is to specifically reduce the role of Fannie Mae and Freddie Mac. MBA believes that the proposed fee for service structure appears to head in the opposite direction. The proposal would reduce the role of servicers to that of a subservicer for Fannie Mae and Freddie Mac. It would move much of the mortgage banking industry’s investment in MSR assets off the balance sheet of servicers and to transfer additional operational risks to Fannie Mae and Freddie Mac.

MBA concludes that the proposed fee structure may further perpetuate and expand the GSEs’ role in future housing finance by contractually putting the GSEs in the middle of the cash flow of servicing compensation for 30 years.

MBA’s Concerns With the Process Used by FHFA in this Project

MBA has a number of concerns about the process used by FHFA in the fee project:

- MBA notes that the Congress created Fannie Mae and Freddie Mac as separate, privately held companies that would compete in the marketplace. MBA notes that the process used to establish the proposed fee structure is for Fannie Mae and Freddie Mac to sit down at the table together, albeit in front of their regulator, to set the fee structure and prices for servicing loans in the future. MBA believes that such pricing process should be designed to be more market-driven. One suggestion is for actual servicing practitioners to be included as part of the working group.

- MBA also notes that, based upon the aforementioned stated objectives of the Obama Administration, that Fannie Mae and Freddie Mac should have a reduced role in the future of housing finance. This attempt to set a pricing structure and the initial price would appear to be moving toward more government involvement and less private market involvement in housing finance.
- Fannie Mae recently purchased from a private enterprise servicer a significant servicing portfolio. This puts Fannie Mae in the position as a direct competitor of private sector servicers. Isn't Fannie Mae's direct involvement in the servicing fee project a potential conflict of interest?
- Fannie Mae and Freddie Mac are in the process of developing a standardized servicer guide. In addition, consumer groups, regulators, state attorneys general and others are calling for more robust servicing requirements. MBA believes that it makes more sense for those standards, which will set the scope of the servicer's future work, to be finalized before future servicer compensation issues are addressed.
- MBA also understands that the GSEs will be increasing G fees. MBA believes that in any fee structure proposal, servicers should be given the entire picture of how the spread between the loan rate and MBS coupon will be used by Fannie Mae and Freddie Mac and how much will be left to cover the originator's expenses and the servicer's future expenses. Once the seller/servicer is given this information and knows what will be required of them in the future, they will be able to analyze the impact of the initiative on profitability and pricing to the consumer.
- MBA also notes that the Discussion Paper contains very little information about servicing fees and other information with respect to NPL servicing. At what point in delinquency is a loan considered NPL? Are existing incentive programs the only incentives or fees that FHFA has in mind for servicing NPLs? Is there a separate fee schedule not included in the Discussion Paper that the GSEs would pay for NPLs that are moved to a special servicer?

Impact on the Borrower

As stated above in comment *Improve Service to Borrowers?*, a reduction in ongoing servicing revenue under the fee for service plan may result in reduced service levels to borrowers. Servicers will be incented to move more toward high tech/low touch servicing and less to high touch/low tech processes. The lack of any added incentives for servicing NPLs may adversely impact customer service in this critical area.

The interest rate and fees paid by the borrower will likely increase for the following reasons:

- Reduction in servicer fee compensation as the GSEs take a larger portion of the spread between the note rate of the mortgage and the coupon rate of the MBS.
- Anticipated G fee increases.
- Additional required servicing processes that will raise servicer costs.
- Reduction in revenues from execution of IO strip related to orphan IOs created each month under the proposed fee for service plan.
- Interest rate increases may result from changes in negative convexity of mortgages related to less servicer “skin in the game.”

On the other hand, reduced fees under the proposal may result in fewer servicers and a less liquid market for MSR. This could reduce the frequency of transfers of servicing. This may be perceived as a benefit to the borrower.

The discussion document indicates that the GSEs will take measures to deal with the perceived concerns with prepayment churn by subjecting all streamlined refinances to net tangible benefit (NTB) tests and monitoring and tracking prepayment speeds of each servicer. MBA notes that most seller/servicers already perform screening of loans to make sure that they target customers that will have an economic benefit from a refinance. MBA believes that whatever additional calculations FHFA establishes should be cost efficient for servicers to implement and utilize. Although these speed bumps to refinances seem innocuous, if improperly designed, they may serve to postpone the point in time that a borrower can lock in a new rate and start realizing the savings from a refinance. Further, even if a servicer is not purposely churning the portfolio, the potential for the imposition of penalties could prevent servicers from investing in the infrastructure to efficiently handle borrower refinance requests.

Impact on the Investor

MBA anticipates the following impact to investors in GSE MBS as a result of the proposed fee for service structure:

- Potentially higher prepayment speeds related to less servicer “skin in the game.”
- Reduced TBA liquidity related to additional prepayment risk.

Impact on the GSEs

The following would be the primary impacts of the proposed fee for service to the GSE's:

Master Servicer Arbitrage Opportunity - The GSEs as master servicer would receive 8 bps of outstanding principal per annum and pay out to the servicer only \$10 per loan per month. The breakeven average principal balance is \$150,000. The average loan size produced in recent months was \$210,000. At 8 bps this would yield \$168 per annum for the GSEs compared with \$120 per annum paid to the servicer for a net arbitrage profit of \$48 or 2 bps.

Obligation to Advance Beyond Four Months - Under the fee for service structure, the servicer would not be required to advance beyond four consecutive delinquent monthly payments. The GSEs would have to advance beyond that or change the TBA structure.

Risk of Servicers Exiting the Business - A radical fee structure change that will likely reduce seller/servicer profits coupled with the significant counterparty risk servicers would now have to the financially troubled GSEs may prompt some servicers to exit the business. This could be highly disruptive especially if exiting servicers are large servicers.

Reduced Servicer Skin in the Game - Under the present servicer compensation structure, servicers generally have an MSR asset on their balance sheet of 1 percent of outstanding principal balance. The GSE's have always considered this servicer skin in the game as a form of collateral to ensure servicer performance. Under the fee for service model, the servicer could monetize a significant portion of the MSR asset at origination, leaving less collateral available to the GSEs.

Increase in IO risk to GSE's - The GSE's would receive bps of principal and pay flat monthly amounts to servicers. This raises the GSE's exposure to prepayment and extension risk.

Impact on the Competitive Landscape

MBA expects the proposed fee for service model may have the following impacts on the competitive landscape:

- Inadequate long-term compensation for small businesses could create additional barriers to entry.
- Less hedging cost and MSR asset management cost may encourage more entities to enter the market.
- Many servicers use servicing as a countercyclical component to hedge production revenue. For example, an increase in rates causes a reduction in MSR decay, and amortization expense, which offsets, in part, the decrease in production revenues related to the higher rate environment. With less MSRs recorded on the balance sheet, this natural "macro hedge" would be lost.

- Bifurcating seller reps and warranties from servicer reps and warranties could make the market for MSRs more liquid. However, this impact will be reduced as there will be much less MSR value to trade under the proposed fee for service structure
- Under the proposed fee for service structure, the GSEs may unilaterally change the fees paid to servicers. This uncertainty could be an additional barrier to entry and may be an additional risk that causes existing servicers to exit the market.

Impact on the Servicer

Counterparty Risk: As mentioned above, the fee for service structure would expose the servicer to a potentially significant new risk. Presently, servicers are paid directly from the principal and interest payments they collect from the borrowers. Under the proposed structure, the servicer's compensation would be paid by the GSE's. Given the fact that the GSEs are now in conservatorship and their future fate is not known, this gives rise to a significant counterparty risk to the servicer.

Loss of Tax Safe Harbor: The language in the existing Revenue Ruling and Revenue Procedures that provide for the existing tax safe harbor carve out a safe harbor for GSE servicing in terms of bps of outstanding principal not fee for service per loan per month. The proposed fee for service structure would not qualify for the safe harbor. In contrast, the proposed cash reserve structure is denominated in bps of principal and would qualify for tax safe harbor.

Even if the servicer elects to keep the IO contractually tied to the MSR asset, upon tax examination, the examiner may conclude that it is still deemed to be a stripped coupon that needs to be taxed currently. That conclusion would likely stem from the fact that the minimum servicing fee is \$10 per loan per month.

Significant Reduction in Ongoing Cash Flows and Reportable Income: Up front revenue and cash flows and ongoing revenue and cash flows will be impacted by the fee for service structure as follows:

GAAP Reportable Net Income at Origination

- Loss of tax safe harbor benefits would adversely impact the initial value placed on the MSR asset and reducing gain on sale.
- If the IO strip is sold to the GSE's for an IO security, the value realized would depend on the liquidity of the market for small orphan IOs or the multiples offered to the servicer if the servicer sells the IO strip to the GSEs' respective grids.

Cash Flow at Origination

- The servicer could monetize more of the spread between the note rate of the mortgage and the coupon rate of the MBS under the fee for service proposal. However, as stated above the value realized would depend on the liquidity of the market for small orphan IOs or the multiples offered to the servicer if the servicer sells the IO strip to the GSEs' respective grids.
- If servicer elects not to monetize the excess IO at origination, the cash flows would likely be significantly worse than today's cash flows at origination because the servicer would have to pay taxes on the IO strip retained.

Ongoing GAAP Reportable Income

- The ongoing income would be significantly reduced for performing loans down to \$10 per loan, per month, for performing loans plus late charges, float benefit, and ancillary income.
- Under the existing compensation structure, if a NPL is brought current, the servicer can capture past due servicing fees plus existing incentive fees. Under the proposed fee for service structure, the servicer would be paid incentive fees only, thus reducing income for NPLs.

Ongoing Cash Flows

- Ongoing cash flows would be significantly reduced for performing loans down to \$10 per loan per month for performing loans plus late charges, float benefit, and ancillary income.
- Under the existing compensation structure, if a NPL is brought current, the servicer can capture past due servicing fees plus existing incentive fees. Under the proposed fee for service structure, the servicer would be paid incentive fees only, thus reducing income for NPLs.
- The proposed cap for advances of P & I would improve cash flows on NPLs.

Dramatically Reduced Compensation for Medium to Large Loans: The GSEs as master servicers would receive 8 bps of outstanding principal per annum and pay out to the servicer only \$10 per loan per month. The breakeven average principal balance is \$150,000. The average loan size produced in recent months was \$210,000. At 8 bps this would yield \$168 per annum for the GSEs compared with \$120 per annum paid to the servicer for a net arbitrage profit of \$48 or 2 bps. This favorable arbitrage for the GSEs would be taken out of the income and cash flows that presently inure to the servicer.

Uncertainty Around Inflation Increases: Although inflation has been reasonably low in recent years, the government's deficit spending could eventually result in inflation.

The servicer, under the proposed fee for service model, is locking in a price for thirty years. Although the proposed structure calls for the GSEs to review the fee annually, this would be a unilateral decision whereby the servicer has no role in the process and the decision would be prospectively applied. This provides the servicer with additional risk.

Loss of Natural Hedge to Production: Many full service mortgage companies use servicing as a natural hedge to loan production. When interest rates rise, production volumes (and often margins) go down, resulting in reduced profit. In this scenario, borrowers have less incentive to prepay their existing mortgages resulting in less portfolio decay and reduced MSR amortization. The opposite is true when rates fall. Production revenues go up and servicing revenues go down.

Under the fee for service model, the MSR value in the balance sheet would be significantly reduced, resulting in a diminished natural hedge to the production side of the mortgage business.

Compliance with Proposed Basel Annex: The Basel Commission has proposed that each member countries' prudential bank regulators adopt new risk-based capital requirements which would severely restrict bank ownership of MSRs. The fee for service model would result in fewer MSRs capitalized, and would help banks to continue to grow their respective servicing portfolios.

It should be noted that one of the permutations of the cash reserve method calls for a reduced payment to the servicer of 12.5 bps of outstanding principal. This was proposed by the Clearing House Group which represents large bank servicers. This more modest change to the servicing fee structure would also serve the purpose of having less MSR capitalized and would also help banks to continue to grow their respective servicing portfolios.

Bifurcation of Seller and Servicer Reps and Warranties: Under the GSEs' existing seller/servicer guidelines, the servicer is responsible not only for servicing reps and warranties but also for seller or originator reps and warranties. The GSEs have been aggressively enforcing seller reps and warranties in recent years, and this has caused the secondary market for GSE MSRs to grind to a halt. The GSEs propose to allow the servicer to pay a fee to bifurcate the seller reps and warranties from servicer reps and warranties in the future under the fee for service structure. MBA believes that this is an excellent idea and could be implemented under a cash reserve servicing fee structure, as well.

Member Concerns about Collectibility of Incentive Payments: MBA notes that the only compensation for servicing NPLs is existing incentive programs. Many of our members have expressed concerns, based upon current history in dealing with the GSEs, that such fees can be unilaterally withheld by the GSEs or the GSEs could otherwise curtail servicer advance recoveries if certain deadlines in the Seller/Servicer

Guides are missed by servicers as a result of the servicer's diligent and conscientious efforts to assist borrowers in loan modification or other loss mitigation programs.

Cash Reserve Method

The Discussion Paper very briefly describes the cash reserve model. It states on page 21, "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 proposed reserve account proposed here." Pursuant to this request, attached as appendices to this comment letter please find a proposed term sheet for the cash reserve structure and an update of the "Good, Bad and Ugly" analysis, previously sent by MBA to FHFA in June 2011, which compares the attributes of the present fee structure, MBA's cash reserve proposal, the Clearing House Group's cash reserve proposal, and the FHFA's fee for service structure. This discusses in great detail the pros and cons of each including capital requirements, tax treatments, cash flows and GAAP reportable income of each, at origination and ongoing.

The only attribute listed in the Discussion Paper on page 21 which is not in the "Good, Bad and Ugly" analysis is the GAAP accounting for the cash reserve structure. MBA finds discussion of GAAP accounting missing from the Discussion Paper with respect to FHFA's proposed fee for servicer structure. So, we request that FHFA perform such analysis and report on their findings.

The only nuance in the cash reserve structure that is different from a GAAP accounting standpoint under today's servicing fee structure is how to deal with the cash reserve from an accounting standpoint. The cash reserve is cash in the MBS trust that ultimately inures to the servicer. The present value of that future cash flow stream should be included in the initial valuation of the MSR asset at origination. If the servicer accounts for the MSR at amortized cost, the periodic impairment testing should include the present value of the expected cash flows from the cash reserve. If the servicer has elected the fair value option for MSRs, the servicer would include the fair value of the cash reserve cash flows in its fair valuation of the servicing asset.

The cash reserve would not be cash listed on the servicer's balance sheet. Rather, it would be included in the value of the MSR asset as described in the immediately preceding paragraph.

MBA acknowledges that proposed cash reserve structure has some notable drawbacks when compared with the FHFA's fee for service structure. It would result in a higher MSR on the balance sheet of the servicer which creates earnings volatility and can be expensive to hedge. The higher MSR may hurt banks if the proposed Basel Annex on servicing is adopted by U.S. bank regulators. If FHFA decides to move forward with a fee structure change, MBA believes that a modest change is more appropriate than a

radical change. Therefore, the majority of MBA members, large and small, believe the cash reserve structure is preferable to the proposed fee for service structure. See the Appendix B for a full list of pros and cons of the present fee structure, the cash reserve fee structure proposals, and the FHFA's fee for service model.

MBA's Response to FHFA's Specific Questions

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?

MBA's Response: For impact on the competitive landscape see MBA's general comment above, *Impact on the Competitive Landscape*. For impact on service to borrowers see general comment, *Improve Service to Borrowers?*, above. If FHFA "efficiency in secondary markets" means impact on TBA for Fannie Mae and Freddie Mac MBS, then see general comment, *Promote Continued Liquidity for TBA for GSE MBS?*, above. If efficiency of secondary markets relates to the efficiency of secondary market for MSR, MBA notes that bifurcation of seller and servicer reps and warranties would indeed result in greater liquidity in the market for MSR. MBA further notes that reps and warranties could be bifurcated under any of the fee proposals. MBA further notes that the fee for service proposal will significantly reduce the amount of MSR capitalized, and this would work to reduce the liquidity of the secondary market for MSR.

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?

MBA's Response: MBA represents the entire spectrum of the real estate finance market in the United States. As such, it represents enterprises with a variety of business models. Accordingly, it is appropriate for MBA's individual members to respond to this question in their respective comment letters. However, MBA believes that the Appendix B, the "Good, the Bad and the Ugly" is a balanced analysis of the pros and cons of each of the fee proposals.

MBA also notes that the fee for service proposal is a radical departure from the existing fee structure that has worked well for decades. The change would turn the entire gain on sale and fee structure “on its head” and likely result in the GSEs taking for themselves an even greater portion of the spread between note rate of the mortgage and the pass-through rate of the MBS. This will be extremely disruptive to the markets and would likely have a dramatic impact on the existing relationships between brokers, correspondent lenders and aggregators.

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?

MBA’s Response: Giving servicers the option of having the excess IO attached or alternatively unattached provides flexibility for servicers with various business models.

a) MBA believes that the resulting “orphan IOs” will get reduced execution in the market because of the relative size. Accordingly, seller/servicers with smaller volume would likely get reduced value in the secondary market than the larger monthly IOs produced by larger seller/servicers.

b) Contractually separating the excess IO from the MSR may create more liquidity and transparency. However, the liquidity for small lots of “orphan IOs” may work in the opposite direction.

c) MBA does not believe that it is necessary to separate the operational activities of servicing from the management of the MSR. Most mortgage companies already treat them separately and have developed and maintain sophisticated MSR asset/liability management systems to optimize the value of the MSR asset.

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?

MBA's Response: See general comment above entitled, *Impact on Borrower*. MBA believes that \$10 per loan per month for performing loans and no additional incentives for NPL servicing will drive the servicer to emphasize high tech/low touch service to borrowers. In contrast, high touch/low tech service for NPLs is the most effective way to service those borrowers.

MBA also notes that investment in NPL operations in a benign market cycle would not appear to make sense. Keeping excess staff on board waiting for the next credit cycle would be a foolish and wasteful use of resources.

The fee for service proposal would likely have an adverse impact on the alignment of servicer and guarantor interests. The servicer would have less "skin in the game," and the proposal offers no compensation for NPLs other than existing incentive programs. MBA notes that under the present servicing fee structure, servicers have significant incentives to bring a loan current. First, servicers capture their normal fees at 25 bps of principal when the borrower pays delinquent payment. There is no such fee recapture under the fee for service model. Second, servicers are incented to bring loans current in order to recapture principal and interest and taxes and insurance advanced on a delinquent loan. MBA further notes that existing incentive fees for NPLs will likely go away as programs such as HARP and HAMP sunset.

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?

MBA's Response: MBA anticipates the following impact to investors in GSE MBS as a result of the proposed fee for service structure:

- Higher prepayment speeds because servicers will have less "skin in the game" in the form of MSRs on their balance sheet.
- Reduced TBA liquidity because of higher prepayment propensity.

Servicers generally will not solicit a borrower for re-finance if there is not a potential net tangible benefit to the borrower. One primary screen they use in deciding which borrowers to solicit is the note rate of the mortgage vs. current market rates. If FHFA wants to maintain liquidity for the GSE MBS TBA, it should make no change or a less radical change to the servicer's compensation structure.

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

MBA's Response:

- a) Bifurcation of seller and servicer reps and warranties should be considered independent of any other changes to the servicing compensation structure. This will promote liquidity of MSR's and force originators to stand behind their own seller reps and warranties.
- b) As stated above, MBA believes that a net tangible benefit test is not necessary for streamlined refinances. If FHFA does require such a test, it should be designed to be straight-forward and simple to administer.
- c) MBA's members believe that the market forces will determine this.
- d) MBA believes that if FHFA feels obligated to make any changes to the existing fee structure, it should minimize those changes. Servicers should be required to advance on NPLs as presently required under the seller/servicer guides. However, when the government or the GSEs implement special forbearance programs, the GSEs need to make certain that such social benefit programs are paid for by the taxpayers not the servicers. Thus, the GSE's need to fund the advances associated with those programs.
- e) The flexibility proposed for excess IO execution should be considered for other fee structures as well.

MBA appreciates the opportunity to share its observations with you. Any questions about MBA's comments should be directed to Jim Gross, Vice President Financial Accounting and Public Policy and Staff Representative to MBA's Financial Management Committee, at (202) 557-2860 or jgross@mortgagebankers.org.

Letter to the FHFA on Servicer Compensation

December 8, 2011

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Yours truly,



Debra W. Still
President and CEO
Pulte Mortgage LLC
Chairman of MBA's Council on Residential
Mortgage Servicing for the 21st Century
Chairman-Elect - Mortgage Bankers Association



David Stevens
President and CEO
Mortgage Bankers Association

Attachments

Term Sheet for Cash Reserve Servicer Compensation Structure

Base Compensation Structure:

Servicers come in a broad range of size and cost to service structures. A large and highly automated servicer can generally service loans at a cost significantly lower than a smaller servicer. Accordingly, the Guide should define “normal servicing fee” as a **“reasonable range of 12.5 bps to 20 bps plus the bps of principal placed in cash reserve for catastrophic NPL servicing.”** This will allow large servicers to monetize more IO strip up-front based upon a less expensive cost structure, while still maintaining adequate “skin in the game” to act as “collateral” for performance of servicing obligations. Smaller, less efficient servicers will be paid up to 20 bps of outstanding principal plus the bps placed in cash reserve for catastrophic NPL servicing. The seller/servicer would have to choose a point within this reasonable range of servicing to use on all MBSs pooled. The seller/servicer could not change this election without prior approval of Fannie Mae or Freddie Mac, or their successors. Fannie Mae and Freddie Mac would review the prepayment history of existing pools and other important performance metrics in making the decision to allow the servicer to change the bps of servicing and could not unreasonably withhold approval of the change.

The charts below show the existing fee structure and the high end and low end of the proposed cash reserve structure:

Current Allocation of Mortgage Interest

Interest rate on mortgage	5.000%	
Guarantee fee	0.200%	Inures to Fannie Mae
Excess servicing	0.050%	Inures to securitizer/servicer and can be monetized or included in MSR asset
Normal servicing	<u>0.250%</u>	Inures to securitizer/servicer
Coupon of Fannie Mae MBS	<u>4.500%</u>	

Proposed Allocation of Mortgage Interest - High End

Interest rate on mortgage	5.000%	
Guarantee fee	0.200%	Inures to Fannie Mae
Excess servicing	0.050%	Inures to securitizer/servicer

Portion of IO strip used to create cash fund for NPL servicing	0.050%	Used to build up a cash reserve in a special "in trust for" servicing cash account to be used for future fee for servicing non-performing loans.
Normal servicing	0.200%	Inures to securitizer/servicer
Coupon of Fannie Mae MBS	<u>4.500%</u>	

Proposed Allocation of Mortgage Interest - Low End

Interest rate on mortgage	5.000%	
Guarantee fee	0.200%	Inures to Fannie Mae
Excess servicing	0.145%	Inures to securitizer/servicer
Portion of IO strip used to create cash fund for NPL servicing	0.030%	Used to build up a cash reserve in a special "in trust for" servicing cash account to be used for future fee for servicing non-performing loans.
Normal servicing	0.125%	Inures to securitizer/servicer
Coupon of Fannie Mae MBS	<u>4.500%</u>	

The unused portion of the IO strip used to create the cash fund for NPL servicing would ultimately inure to the servicer and would be distributed to the servicer as described further in this term sheet.

The cash reserve structure would make only a minor, but important change to the existing fee structure. With part of the servicer's present contractual cash flow, 3 to 5 bps would be placed in a cash reserve within the MBS trust's cash to be used for catastrophic NPL costs and incentives as warranted. It is anticipated that this would be used only in the most severe economic and delinquency scenarios such as the single-family mortgage market has experienced in the past few years. This fund would be created for catastrophic delinquency experiences within the respective MBS commencing with the new compensation plan and not for prior pools.

Discretionary Incentives

The GSE's could continue to pay discretionary incentives for NPLs from their G Fees in order to reduce frequency of default or loss severity.

Contractual Requirements

Since the cash reserve compensation method represents minimum change to the present contractual arrangements between servicer and the GSE's, today's contractual requirements should generally be preserved. See proposed changes herein and in the section entitled *Bifurcation of Reps and Warranties* and *Cash Reserve Fund* below.

Servicing requirements for performing loans and NPLs will be defined by the GSE's through their respective Guides as finalized in the SAI initiative. Further, servicing standards are in a state of flux as a result of regulator action, attorneys general law suits, and the call for a national servicing standard. Any change or series of changes in such requirements that would result in a material increase in servicer duties or expense should be paid for by the GSE's on a fee for service or incentive fee basis in a manner that will make the servicer whole. This cost should come from the G fee paid to the GSEs or from the borrower's monthly payments.

Servicer will make P & I advances as per the Guide. However, if the federal government or the GSEs implement loss mitigation procedures that would extend the period a servicer would normally be required to advance, the GSEs must make arrangements to compensate the servicer for the added expense and use of the servicer's liquidity.

The GSEs will have the option to transfer servicing for cause in accordance to present GSE Guides. Unlike existing Guides, the GSEs may also choose to transfer portions of the servicing portfolio for cause and to transfer to the successor servicer proportional cash reserves.

Excess IO

Seller/servicers may continue with existing options to realize excess IO including, but not limited to, retaining the excess IO strip, selling to the GSE's respective grids, swapping up coupon, and securitizing the IO strips. Further, servicers should have the option to hold and transfer IO strips that are contractually independent of the servicing asset.

Bifurcation of Reps and Warranties

Servicer shall have the option to bifurcate seller reps and warranties from servicer reps and warranties in exchange for a fee to be negotiated with the GSEs. This will serve to make the secondary market for MSR more liquid and to facilitate MSR price/value discovery for accounting purposes. GSEs would then only look to the loan originator to stand behind seller reps and warranties.

Cash Reserve Fund¹

Guiding Principles

- **Structure:** The reserve should be built up over time by placing a small portion of the mortgage cash flow (e.g., 3 bps) into a custodial reserve account. The account should be tied to a particular vintage of loans, with unused portions eventually refunded to the mortgage servicer if they are not required to cover unanticipated operating costs of the servicer. Use of the reserves should be the exception, not the rule, and would not be expected to occur under normal market conditions.
- **Segregation of funds:** The reserve should be protected if either the guarantor or the servicer fails. This will ensure that the necessary funds are available to meet unanticipated servicing costs.
- **Ownership:** The reserve should be “owned” by the mortgage servicer, as opposed to the investor/guarantor. This will create an incentive for quality servicing and ensure that the reserve fund survives any future restructuring of the GSEs. The servicer should have the ability to earn income from the reserve, subject to certain restrictions on how the funds are invested.
- **Portability:** The reserve should follow the servicing rights, with unused balances transferred to the new servicer if servicing rights are sold or transferred for cause. This arrangement will facilitate the transfer of servicing and ensure that the funds continue to be available to meet unanticipated operating costs. A fixed dollar amount per loan should be used to set the accompanying reserve amount for the partial transfer of servicing. This schedule would be set by the guarantor and subject to periodic adjustments.
- **Access:** Access to the reserve should be triggered by the onset of unanticipated NPL-servicing costs that result from a deterioration in the economic environment, shifts in public policy, or other unanticipated events. Once the reserve is activated, it should continue to be available until the economic environment improves.
- **Use:** The Reserve should only be used to cover unanticipated servicing costs. Expected costs should be covered by the general operating funds of either the servicer or guarantor. Cost structure and process changes resulting from current agreements with regulators (e.g., consent orders) should be part of the servicer’s expected costs and covered under the MSF. The reserve should not be used to replace the current reimbursement structure for specific foreclosure and loss-

¹ The Clearing House Group, Letter to Mr. Mario Ugoletti, Mr. David Hisey, Mr. Brian Pommer, and the Honorable Ted Tozer, June 10, 2011.

mitigation activities, nor should it be used to cover penalties or provide incentives established by the guarantor.

- **Release of Reserves:** Once the servicers' aggregate reserves reach a certain threshold—which we provisionally assume should be 10 bps of the servicer's total book for a given guarantor (for reserve pools only)—funds for individual vintages should be subject to release depending on the performance of the vintage. Regardless of performance, no funds should be available for release if such an action would cause the servicer's aggregate reserves to fall below the designated level.

Access to the Fund

Access to the reserve account would be triggered by the onset of certain conditions established in the mortgage contract. At a minimum, the triggering events should include:

- A deterioration in the broad economic environment; for example, an increase in the investor's delinquency roll rate and/or incidence of loans that have ever been 90 days past due ("ever-90 loans") above a certain pre-established level; and
- A change in law, regulation or investor-servicing protocols that increases the cost of mortgage servicing.

The experience of individual servicers with respect to their peers could also be used as an additional trigger to capture situations that are unique to individual servicers (e.g., geographic concentration in an economically declining area). However, if adopted, any such trigger would have to be constructed in a way that maintains the incentive for quality servicing.

Use of the Fund

Once access to the funds is triggered, use of the reserves would be fungible over different vintages of loans for a given guarantor, and servicers would have broad flexibility in using the funds to meet their operational needs. However, the reserve would not be used to cover any penalties incurred under the recently announced common servicing standards, nor would they replace existing activity-based reimbursement fees associated with the foreclosure process or real-estate-owned management.

Servicers' use of the funds would be transparent and subject to regular audits by the guarantor. If the use of the funds was found to violate the terms of the servicing contract or otherwise to jeopardize the continued servicing of the loans, the guarantor would have the right to transfer the servicing rights for cause.

If servicing is transferred for cause, a specific payment schedule for NPL activities would be used to determine the level of reserves that would follow the servicing

contract. This payment schedule would be part of the original servicing contract and re-examined on a periodic basis to ensure that it reflects the costs of servicing NPLs.

Release of Funds

Once the servicer's aggregate reserve funds reach a certain share of its overall book (which we provisionally assume should be 10 bps of the servicer's total book of cash reserve servicing pools for a given guarantor), funds for specific vintages would be eligible for release to the mortgage servicer. However, funds for a specific vintage would only be released if (1) the vintage was at least four years old, (2) the number of ever-90 loans was below a certain pre-established level (e.g., 2 percent) and (3) release of such funds did not cause the size of the aggregate reserves to fall below the requisite level.

Once such funds were released, the servicer would have the right to sell the remaining strip or receive the remaining cash flow as general revenues. After that point in time, the vintage would no longer provide a funding source for the servicer's aggregate reserves.

Eligibility for release would be determined on an annual basis, beginning four years after the change in the servicing-compensation structure. If funds for a particular vintage are not released, they would continue to accumulate until the next annual accounting review. As a result, aggregate reserves would typically exceed the threshold established by the servicing contract.

The adequacy of total reserves would be based on the portion of the servicer's book that was initiated after the compensation change. Older (i.e., legacy) vintages would not be subject to the reserve requirement, nor would they be used to calculate the adequacy of the servicer's total reserves.

**Mortgage Bankers Association
 Servicing 21 Council
 Analysis of FHFA's Fee Proposals Primarily from the Perspective of MSR Holders**

<u>Attributes for Analysis</u>	Present Fee Structure	MBA's Reserve Account Proposal	Reserve Account Proposal	Monthly Fee for Servicing
<p><i>Stated objective of FHFA's Project: Improve service to borrowers.</i></p> <p>Improvement of service to borrowers?</p>		<p>Servicer would set aside 5 bps for NPL servicing. This could potentially improve service to borrowers</p>	<p>Servicer would set aside 3 bps for NPL servicing. This could potentially improve service to borrowers</p>	<p>No compensation to servicers other than existing incentive compensation for the servicing of NPLs.</p>
	Likely	Likely	Service levels may go down	

**Mortgage Bankers Association
 Servicing 21 Council
 Analysis of FHFA's Fee Proposals Primarily from the Perspective of MSR Holders**

<u>Attributes for Analysis</u>	Present Fee Structure	MBA's Reserve Account Proposal	Reserve Account Proposal	Monthly Fee for Servicing
<i>Stated objective of FHFA's Project: Reduce financial risk to servicers.</i>				
Prepayment risk?		Little change	Reduced risk	Prepay speeds may increase, but less impact because of reduced MSR's
Risk of cost inflation?		Less risk because sufficient base service fee	Added risk because lower base service fee	Significant reduction in base service fee.
Compensation for unusual NPL costs?		Better	Good	No stated additions to NPL compensation
Counterparty risk to GSE's (see below)		Good	Good	Ugly

**Mortgage Bankers Association
 Servicing 21 Council
 Analysis of FHFA's Fee Proposals Primarily from the Perspective of MSR Holders**

<u>Attributes for Analysis</u>	Present Fee Structure	MBA's Reserve Account Proposal	Reserve Account Proposal	Monthly Fee for Servicing
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<i>Stated objective of FHFA's Project: Promote continued liquidity for TBA for MBS.</i>				
Skin in the game to prevent servicer from re-financing the portfolio?	Good	Reduced	Little if any skin in the game	
Adequate servicer compensation?	Yes	Reduced	No	

**Mortgage Bankers Association
 Servicing 21 Council
 Analysis of FHFA's Fee Proposals Primarily from the Perspective of MSR Holders**

<u>Attributes for Analysis</u>	Present Fee Structure	MBA's Reserve Account Proposal	Reserve Account Proposal	Monthly Fee for Servicing
<i>GAAP Reportable Net income at Origination : This attribute compares income reportable under generally accepted accounting principles (GAAP) at the time the mortgage servicing right (MSR) is created.</i>				
Pre-tax	60 bps	This was not modeled in FHFA's proposal, but would resemble the existing servicing fee structure.	This was not modeled in FHFA's proposal, but would resemble the existing servicing fee structure.	If servicer keeps IO strip, would likely lose value of the tax safe harbor. If they sell to GSEs for an IO security, value would depend on the ultimate liquidity of market for small lot IO securities.
GAAP reportable tax	(21) bps			
After tax	39 bps			
For reporting entities that are public or otherwise are concerned about earnings and EPS:	Good	Good	Good	Bad
Note: The figures in the table are from FHFA's February presentation.				

**Mortgage Bankers Association
 Servicing 21 Council
 Analysis of FHFA's Fee Proposals Primarily from the Perspective of MSR Holders**

<u>Attributes for Analysis</u>	Present Fee Structure	MBA's Reserve Account Proposal	Reserve Account Proposal	Monthly Fee for Servicing
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Ongoing GAAP Reportable Income: *This attribute compares ongoing income reportable under GAAP. There are two facets to this analysis. The first relates to the ongoing income based upon the fee structures after the MSR asset is created. The second facet relates to the volatility of the MSR asset. The principal driver of MSR values relates to prepayment speeds. If rates go down, borrowers have a higher propensity to re-finance their mortgages. When a borrower pays off his or her mortgage prior to maturity, the MSR associated with that loan goes to a zero value. Under the present fee structure, prepayment risk is the greatest concern.*

Description of Ongoing GAAP Reportable Income

25 bps of outstanding principal balance plus float, late charges and ancillary income make for potentially strong earnings. But prepayment risk and hedging costs make this potentially volatile.

20 bps of outstanding principal plus float, late charges, ancillary income, and residual income from cash reserve. Prepayment risk and hedging cost would be similar to present fee structure.

12.5 bps of outstanding principal balance plus float, late charges and ancillary income--- significantly reduced potential income, but less income volatility.

The ongoing income would be significantly reduced for performing loans down to \$10 per month and for non-performing loans compensation limited to existing incentives. Servicer would still receive float, late charges and ancillary income.

Ongoing GAAP Income:

Potential income stream

Good

Good

Reduced

Ugly

Potential volatility

Ugly

Ugly

Bad

Good

Note: Analysis assumes retaining only the minimum strip.

**Mortgage Bankers Association
 Servicing 21 Council
 Analysis of FHFA's Fee Proposals Primarily from the Perspective of MSR Holders**

<u>Attributes for Analysis</u>	Present Fee Structure	MBA's Reserve Account Proposal	Reserve Account Proposal	Monthly Fee for Servicing
<i>Payment for Non-performing Loans (NPLs): This attribute compares compensation for NPLs for each of the fee structures.</i>	Servicer is paid existing incentives under HAMP, HARP and other programs. In addition, the servicer recovers past due servicing revenue when a loan is brought current.	Servicer is paid existing incentives under HAMP, HARP and other programs. In addition, the servicer recovers past due servicing revenue when a loan is brought current.	Servicer is paid existing incentives under HAMP, HARP and other programs. In addition, the servicer recovers past due servicing revenue when a loan is brought current.	Servicer is paid existing incentives under HAMP, HARP and other programs and would not recover fees on loans when they are brought current.
Comparison	Good	Good	Good	Bad

**Mortgage Bankers Association
 Servicing 21 Council
 Analysis of FHFA's Fee Proposals Primarily from the Perspective of MSR Holders**

<u>Attributes for Analysis</u>	Present Fee Structure	MBA's Reserve Account Proposal	Reserve Account Proposal	Monthly Fee for Servicing
<i>Cash Flows at Origination: The cash flows at origination relate to the comparison of proceeds from sale or securitization of mortgages vs. the originator's underlying cash costs to originate and sell or securitize the loan</i>				
Cash flows at origination				
Pre-tax cash flows	(68) bps	This was not modeled in FHFA's proposal, but would resemble the existing fee structure.	This was not modeled in FHFA's proposal, but would be higher than the existing servicing fee structure as additional IO strip is could be monetized at origination	This was not modeled in FHFA's proposal. However, cash flows at origination would be similar to existing cash flows if servicer elects not to monetize the IO strip. Cash flows would be better if IO are monetized.
Tax cash flow	24 bps			
After tax flow	(44) bps			
For reporting entities that are concerned about cash flows at origination	Ugly	Ugly	Better	Depends
Note: The figures in the table are from FHFA's February presentation.				

**Mortgage Bankers Association
 Servicing 21 Council
 Analysis of FHFA's Fee Proposals Primarily from the Perspective of MSR Holders**

<u>Attributes for Analysis</u>	Present Fee Structure	MBA's Reserve Account Proposal	Reserve Account Proposal	Monthly Fee for Servicing
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<p>Variability of IO Strip Values: Under the Clearing House's and FHFA's fee structures, much of the interest strip available to the originator/servicer can be sold into the market as an interest-only (IO) strip. Thus, much of the upfront GAAP reportable income and cash flows relate to how robust the market for such IO strips is at the moment. The originator has numerous market execution options for that IO strip. For example, they can "swap up coupon" and create an MBS with a higher yield to the MBS investor, they can sell the strip to Fannie Mae or Freddie Mac (selling to the grid), or the GSE's can create an IO security (in FHFA's proposal).</p>			
<p>Assuming the sale of IO strip-- variability of IO values for those selling a greater IO strip, the P&L and cash flow can be highly volatile.</p>	Good	Bad	Possibly Ugly

**Mortgage Bankers Association
 Servicing 21 Council
 Analysis of FHFA's Fee Proposals Primarily from the Perspective of MSR Holders**

<u>Attributes for Analysis</u>	Present Fee Structure	MBA's Reserve Account Proposal	Reserve Account Proposal	Monthly Fee for Servicing
<p>Ongoing Cash Flows: <i>Ongoing cash flows, like ongoing GAAP reportable income has two facets. The first relates to the ongoing cash revenue based upon the fee structures after the MSR asset is created. The second facet relates to the volatility of the MSR asset. The principal driver of MSR values relates to prepayment speeds. If rates go down, borrowers have a higher propensity to re-finance their mortgages. When a borrower pays off his or her mortgage prior to maturity, the servicing cash flows related to that mortgage go away. Under the present fee structure, this prepayment risk is the highest.</i></p>				
<p>Description of ongoing cash flows</p>	<p>25 bps of outstanding principal balance plus float, late charges and ancillary income</p>	<p>20 bps of outstanding principal balance plus float, late charges and ancillary income. In addition, servicer would receive residual cash from cash reserve for NPLs.</p>	<p>12.5 bps of outstanding principal balance plus float, late charges and ancillary income. In addition, the servicer would receive residual cash flow from cash reserve for NPLs.</p>	<p>The ongoing cash flows would be significantly reduced for performing loans down to \$10 per month per loan and to only existing incentive compensation for NPLs.</p>
<p>For reporting entities concerned about ongoing cash flows:</p>				
<p>Low Prepayments</p>	Good	Good	Reduced Fee	Ongoing Cash Flows Are Low But Less Prepayment Sensitive
<p>High Prepayments</p>	Ugly	Ugly	Bad	
<p>Note: Analysis assumes retaining only the minimum strip.</p>				

**Mortgage Bankers Association
 Servicing 21 Council
 Analysis of FHFA's Fee Proposals Primarily from the Perspective of MSR Holders**

<u>Attributes for Analysis</u>	Present Fee Structure	MBA's Reserve Account Proposal	Reserve Account Proposal	Monthly Fee for Servicing
<p><i>Risk-based Capital Treatment for Depository Institutions:</i> Banks must maintain specified minimum capital levels under the bank regulations. One of the major drivers for a potential change in servicing fee structures relates to a possible adverse change in the way MSR's are treated under bank risk-based capital rules. On July 26, 2010, the oversight body of the Basel Committee on Banking Supervision (Basel Committee) approved an annex to the Basel accord which is an international agreement that establishes capital standards for financial institutions. The annex specifically guides respective member countries' bank regulators to adopt rules for the treatment of specific assets in determining Tier I capital for regulatory reporting purposes. Under the annex, the following assets may receive only limited recognition when calculating the common equity component of Tier I capital, with recognition for each class of assets capped at 10 percent of the common equity component of Tier I capital: a) significant investments in the common shares of unconsolidated financial institutions (banks, insurance and other financial entities), b) Mortgage servicing rights, and c) deferred tax assets (DTAs) that arise from timing differences. In addition, under the annex a bank must deduct the amount by which the aggregate of the three items above exceeds 15 percent of its common equity component of Tier I. Thus the more a bank capitalizes in MSR's for a given loan, the greater the potential capital that may have to be maintained to support that MSR asset. The MSR assets capitalized under the existing fee structure would require potentially more capital than under the reduced fee structures.</p>				
Description of fee structures' impact on risk-based capital treatment for depository institutions	MSR's would be limited to no more than 10% of Tier I capital.	MSR's would be limited to no more than 10% of Tier I capital.	Fewer MSR's capitalized -- would be better than existing fee structure.	Probably little if any MSR capitalized.
For non-depository servicers	No Impact	No Impact	No Impact	No Impact
For depository institutions concerned about Basel treatment of MSR's:	Ugly	Bad	Better	Good

**Mortgage Bankers Association
 Servicing 21 Council
 Analysis of FHFA's Fee Proposals Primarily from the Perspective of MSR Holders**

<u>Attributes for Analysis</u>	Present Fee Structure	MBA's Reserve Account Proposal	Reserve Account Proposal	Monthly Fee for Servicing
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Benefit from Tax Safe Harbor: To understand the tax treatment of MSRs, it is important to understand the allocation of mortgage interest in a MBS. The following is an example of how interest is allocated in a typical Fannie Mae or Freddie Mac MBS:

Current Allocation Of Mortgage Interest

Interest rate on the mortgage	5.50%	
Guarantee fee	0.20%	Inures to guarantor/investor
Excess servicing rights	0.05%	Inures to the servicer
Normal servicing rights	0.25%	Inures to the servicer
Coupon of Fannie Mae MBS	5.00%	Inures to the MBS holder

In 1991, the Internal Revenue Service issued Revenue Ruling 91-46 which provides that to the extent that the servicing contract entitles the institution to receive amounts that exceed "reasonable compensation" for services to be performed (often called "excess servicing rights"), these amounts must be treated under the tax rules that deal with "stripped coupon" bonds which are taxed currently. A "MSR Safe Harbor" for servicing one-to-four unit residential mortgages was provided to determine the amount that was attributable to "reasonable compensation," which is often called "normal servicing rights". Under the MSR Safe Harbor, reasonable compensation is the sum of "float income", certain late fees and escrow fees, plus a .25 percent of outstanding principal serviced for conventional, fixed-rate mortgages. Thus, the part of the mortgage interest related to "normal servicing rights" is treated as compensation for future services, and that portion is not currently taxable. To the extent the servicing rights exceed the MSR Tax Safe Harbor amounts (the "excess servicing rights") they are treated under the "stripped coupon" tax rules.

Discussion of benefit from tax safe harbor for each fee structure	Today, servicers can shelter from immediate taxable income the gain on sale associated with 25 bps for Fannie Mae and Freddie Mac.	Safe harbor would be substantially the same as existing structure because it would include the gain on sale related to 20 bps of servicing fee plus the 5 bps cash reserve.	Safe harbor would be reduced to the gain on sale related to 12.5 bps of servicing fee plus the cash reserve.	No safe harbor because fee is denominated in dollars per loan vs. bps of principal balance.
Impact on servicers of safe harbor	Good	Good	Reduced	Ugly

**Mortgage Bankers Association
 Servicing 21 Council
 Analysis of FHFA's Fee Proposals Primarily from the Perspective of MSR Holders**

<u>Attributes for Analysis</u>	Present Fee Structure	MBA's Reserve Account Proposal	Reserve Account Proposal	Monthly Fee for Servicing
<i>Volatility of MSR Asset: See explanation above for Ongoing GAAP Reportable Income.</i>				
Volatility of MSR Asset	Large IO strip that is extremely sensitive to drops in interest rates	Large IO strip that is extremely sensitive to drops in interest rates	Less of an IO strip that is extremely sensitive to drops in interest rates.	No IO strip, no volatility.
For servicers concerned about interest rate/prepayment risk:	Ugly	Ugly	Bad	Good

<i>Hedging Costs: Many servicers hedge their servicing rights against mortgage prepayment risk. This hedge can be costly based upon a number of factors including interest rate volatility. Servicers must also incur a fixed cost to accumulate the human capital needed to manage the hedging, either by hiring internal talent or outsourcing to external experts.</i>				
Hedging Costs	Ugly	Ugly	Bad	Good

**Mortgage Bankers Association
 Servicing 21 Council
 Analysis of FHFA's Fee Proposals Primarily from the Perspective of MSR Holders**

<u>Attributes for Analysis</u>	Present Fee Structure	MBA's Reserve Account Proposal	Reserve Account Proposal	Monthly Fee for Servicing
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<p>Liquidity of TBA Market: Presently Ginnie Mae, Fannie Mae and Freddie Mac securities meeting certain criteria are categorized by the Securities Industry and Financial Markets Association (SIFMA) as “to be announced” (TBA) securities, whereby they are sold and held widely and are deemed to be homogeneous and fungible enough that they can generally be sold in the forward sale market. This liquidity of the security type is key to keeping interest rates low for consumers. Any change in servicer fee structure may change market perception of the security type. For example, if the market believes a servicing fee structure may lead the originator to re-finance (“churn”) the portfolio, this may lead to a less desirable security type.</p>				
Liquidity of TBA Market	The TBA market for Fannie, Freddie has historically been very liquid until the recent crisis.	Expected to have similar profile as existing servicing fee structure.	Less servicer skin in the game may result in slightly higher prepayments.	Significantly less servicer skin in the game may result in higher prepayments.
Liquidity of TBA market	Good	Good	Lower But Sufficient	Ugly
<p>* Note: Market participants presently have compensation recapture mechanisms to act as a speed bump to prevent loan officers, correspondents and wholesalers from churning. The proposals would eliminate a portion or all of the built in incentive that prevents churning. In the case of the reduced servicing fee, there would be less skin in the game.</p>				

**Mortgage Bankers Association
 Servicing 21 Council
 Analysis of FHFA's Fee Proposals Primarily from the Perspective of MSR Holders**

<u>Attributes for Analysis</u>	Present Fee Structure	MBA's Reserve Account Proposal	Reserve Account Proposal	Monthly Fee for Servicing
<p>Guarantor or Insurer Counterparty Risk: Presently Fannie Mae, and Freddie Mac have counterparty risk with respect to servicers' performance and ability to stand behind representations and warranties. What presently mitigates this risk is the servicing fee capitalized on the servicer's books. If servicers do not stand behind their reps and warranties and/or do a good job servicing the loans, they could lose their servicing and suffer a write down for the MSR asset. The proposed \$10 per month fee structure would result in significantly less MSR's recorded on the balance sheet giving servicers less "skin in the game." There is the potential that MSR's could be capitalized as a liability for some institutions that have relatively high costs to service.</p> <p>Guarantor or insurer counterparty risk</p> <p>Counterparty risk to guarantor or insurer if no collateral or other additional "skin in the game."</p>	<p>At least 100 bps of MSR's capitalized on servicer's balance sheet. Plenty of servicer "skin in the game."</p> <p>Good</p>	<p>At least 80 to 85 bps of MSR's capitalized on servicer's balance sheet. Plenty of servicer "skin in the game."</p> <p>Good</p>	<p>Approximately 50 bps of MSR's capitalized on servicer's balance sheet. A fair amount of servicer "skin in the game."</p> <p>Less but still adequate skin in the game</p>	<p>Little if any servicer "skin in the game."</p> <p>Very Ugly</p>

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Barriers to Entry to Servicing Business: *Present barriers to entry include the economies of scale, technology investment, trained employees, and capital to support investment in MSR asset. Sufficiency of revenue is also a driver.*

Present Barriers to Entry:

Trained employees	Status Quo	No Impact	No Impact	No Impact
Technology	Status Quo	No Impact	No Impact	Need High Tech/Low Touch
Hedging expertise	Expertise Needed	Expertise Needed	Reduced Need	Reduced Need
Critical mass to be efficient	High MSR Investment	High MSR Investment	Reduced MSR	Low MSR
Capital to support MSR asset	High MSR Investment	High MSR Investment	Reduced MSR	Low MSR
Sufficiency of revenue	Highest Revenue	Slightly Lower Revenue	Reduced Revenue	Low Revenue

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Consolidation of Servicing Industry: <i>The trend of MSR ownership during the last ten years has been for consolidation of servicing to the top servicers. This attribute relates to whether that trend would change as a result of the adoption of one of the proposed fee structures or by the Basel Annex, if adopted by U.S. bank regulators.</i>				
Basel Annex not adopted	Continued Consolidation	Continued Consolidation	Potentially More Consolidation	Potentially More Consolidation
Basel Annex adopted	Trend Toward Less Consolidation	Trend Toward Less Consolidation	Continued Consolidation	Potentially More Consolidation

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<p>Servicer Counterparty Risk: Presently, servicing fees are paid directly from the cash flows of the MBS. Under FHFA's proposed fee structure, the servicing fee would be paid by the GSEs. This introduces a level of counterparty risk to the servicer especially in light of the recent Obama Administration white paper that announced plans to eliminate ("wind down") Fannie Mae and Freddie Mac over time. In light of this and other pending changes such as proposals for a national servicing standard, the vast majority of the Council members believe that now is not the right time to change the servicing compensation framework.</p>				
Counterparty risk of the servicer to the guarantor for cash on NPL servicing.	Good	Good	Good	Very Ugly

<p>Large vs. Small Average Loan Size: The operating cost to service a large principal loan is generally about the same as the cost to service a small principal balance loan. Thus, a fee denominated in bps of principal is favorable for high average principal loans and disadvantageous for low principal balance loans. Moving to a pure fee for service structure would level this playing field making it advantageous to service small principal balance loans as well. It would, however significantly reduce fees on larger principal balance loans.</p>	
Service high principal balance loans	Reduced Income
Service low principal balance loans	Improved Income

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In its report to Congress in February 2011, the Obama Administration state its objective of significantly reducing the government's role in the future of housing finance. To what extent does the fee structure proposal remain true to that objective?

More, less or same level of government involvement?	Same	Same	Same	More Involvement
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Fed Governor Raskin and others have expressed the idea that servicers are overpaid for performing loan (PL) servicing and underpaid for non-performing loan (NPL) servicing. They desire that any change in fee structure should resolve this. However, since this is one of the attributes still important to certain government officials and consumer groups, MBA includes it in this analysis.

Greater compensation for NPL and less compensation for PL?	Status Quo	Cash reserve set aside for NPL	Cash reserve set aside for NPL	Reduced comp for PLs and same comp for NPLs.
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