



December 26th, 2011

Edward DeMarco
Acting Director
Federal Housing Finance Agency
1700 G Street, NW
4th Floor
Washington, DC 20552
Servicing_Comp_Public_Comments@fhfa.gov

Re: Alternative Mortgage Servicing Compensation Discussion Paper

Dear Mr. DeMarco:

Quicken Loans Inc. (“Quicken Loans”) is pleased to submit its comments on the Federal Housing Finance Agency’s (“FHFA”) discussion paper that proposes a number of alternative mortgage servicing compensation methods. By way of background, Quicken Loans is an independent Detroit, Michigan-based mortgage bank whose primary business is originating, securitizing and servicing conventional, FHA and VA residential mortgage loans. We have been in business since 1985, and have approximately 4,000 employees. We originate and service loans in all 50 states and are one of the nation’s five largest retail mortgage lenders, one of the three largest FHA mortgage lenders, and the largest online lender. We closed over \$28 billion in retail mortgages, helping over 135,000 homeowners in 2010. As of November 30th of this year we serviced over 100,000 loans representing over \$20 billion of principal balance on behalf of Fannie Mae, Freddie Mac, Ginnie Mae and other private investors.

General Comments

We applaud the FHFA’s in depth study and exploration of a variety of alternative servicing compensation methods in hopes of addressing the three primary objectives: (1) improved service to borrowers, (2) reduction of financial risk to servicers, and (3) more flexibility for guarantors, while promoting and preserving continued liquidity in the TBA market. Although each of the alternatives addresses portions of one or more of the three primary objectives, as proposed, they all lack enough

information for us to reach a firm conclusion on which one is the best alternative, if at all, to the existing method. We do believe that the alternatives have merit worthy of further exploration, and of particular interest is the Fee for Service – Excess IO Option B. Therefore, we strongly encourage the FHFA to provide additional detailed information that addresses the industry’s many unanswered questions, including those outlined in this letter, and re-issue the proposals for further comment.

We recognize that change is inevitable, and given the enormous struggles both Fannie and Freddie (the “Enterprises”) and the mortgage servicing industry have had reacting to and managing through the most recent real estate meltdown it is incumbent upon our industry to improve upon the existing system. However, there is legitimate concern that the unknown consequences of any changes to core fundamentals of the mortgage market, like servicing compensation, could derail the very fragile housing and economic recovery underway. The current servicing compensation system has severe flaws. Those flaws lead to super-concentration of mortgage servicing rights into a few hands, make a secondary market for MSR’s nearly impossible, and, as a result, reduce the ability of the industry to pass through true economic value to consumers. Although certainly not perfect, the current system isn’t fundamentally broken to the extent it requires immediate changes for the sake of change itself. That said, we believe the aforementioned flaws require that a strong effort be made to come up with a system that better suits today’s mortgage industry.

The information we seek to enable Quicken Loans to take a firm position on a new servicing compensation system falls into three categories.

1. The idea of determining an entirely new compensation system is premature without first understanding all of the fundamental and specific duties of the servicer in light of (a) the ongoing industry litigation and subsequent impact to servicing obligations, (b) the Consumer Financial Protection Bureau’s review, (c) the impact of new QRM rules on servicing, and finally (d) the Enterprises new servicing standards. We understand that the Enterprises need the ongoing flexibility to tweak their servicing guidelines as new technologies, loan products and other market changing forces require small adjustments, but given we all know that *major* changes are being considered to fundamental servicing processes, tactics, and strategies, it just makes sense to finalize those obligations *before* deciding how much we’re going to earn performing them.

2. A number of important mechanical, accounting, and tax questions remain unanswered around each of the proposals. A few of the many discussed in more detail throughout this letter are:
 - What exactly is the FHFA’s minimum servicing fee? Is it subject to change? If so, how and when? Does any change impact existing servicing or just new servicing?
 - How will a reduction in the minimum servicing fee for Enterprise loans impact the current tax safe harbor provision?
 - What are the specific restrictions for excess IO in any given pool? What does “excessive” prepayment mean? How is it measured? What kinds and how much are the penalty “fees” that the Enterprises impose related to excessive prepayment speeds?
 - What are the specific changes to the Enterprise’s minimum net worth requirements under a Fee for Service model? How much is the one-time bi-furcation fee?
 - How will the reserve fund monies be released to the servicer? Where will these funds be held? Who will control these funds?
3. Specific details around the entire subject of servicing compensation for nonperforming loans (“NPLs”) are entirely lacking despite the 36 page length of the Discussion Paper. Given that two of the FHFA’s three primary objectives are mostly impacted by nonperforming loans this subject area deserves a great deal of exploration, description, and clarity. Our experience is that, “What happens to NPLs?” is the single most often asked and least often answered question among industry participants as they discuss these servicing compensation proposals. It seems a shame not to use this process to put forth concrete ideas and solicit input. One could argue that the wholly inadequate ability of the servicing industry to manage nonperforming loans and how borrower service was impacted as a result is the very reason a new servicing compensation plan is on the table. NPL compensation details, processes, and mechanics should not only be part of the initiative, but perhaps the cornerstone of it.

Current Servicing Compensation Issues

Our current servicing compensation model remains viable and, except during the most recent housing downturn, has been adequate for decades. Unfortunately, the broken part, of the current compensation model is that it promotes a “cost shop” mentality since revenue growth comes from

driving costs down with scale and process automation. This works well for performing loans, but is in direct conflict with the high touch, individually unique demands required to service delinquent borrowers. The current model relies on an outsized servicing fee on performing loans to subsidize the \$0 servicing fee for non performing loans. Although conceptually sound (and practically sound in all but the most recent downturn), this approach falls short of addressing the fundamental need for the servicing industry to invest in lost mitigation technologies and have the capacity to service NPLs. Unfortunately, the Fee for Service model addresses performing loan servicing, while remaining vague about NPL servicing. The Reserve Account model does address NPL servicing through the reserve, but the proposal lacks enough detail to determine how a reserve will promote NPL servicing in a way that wouldn't see similar results to the past few years. In the end, NPL servicing compensation is the key missing component in not only the existing model, but the alternatives as well.

Likewise, although the Enterprises have the legal right to transfer their servicing to different lenders, the widespread use of such power would severely diminish the number of companies interested in servicing new loans and potentially bankrupt those impacted by such a transfer. This hamstring the Enterprises from proactively managing their servicing vendors to minimize losses during stressful economic times like today.

Reserve Account

We agree that the Reserve Account method offers modest changes to the existing servicing compensation structure. As proposed, this method does not adequately address either the servicer risk or the guarantor flexibility objectives set forth by the FHFA. It is the only proposal, albeit lacking in detail, to address in any regard servicing NPLs. Other than the mechanism to control and access the reserve account itself, this alternative is virtually the same as our existing structure. To the extent the minimum servicing fee component drops from 20 basis points toward the 8 basis points contained in Fee for Service, this alternative better meets the FHFA objectives.

Without significantly more detail about how the reserve account functions, this proposal is extremely difficult to evaluate. Answers to the following questions would help clarify this alternative.

- How will the reserve fund monies be released to the servicer? Where will these funds be held? Who will control these funds?

- How would this plan impact the tax safe harbor?
- If the reserves are maintained at the loan level, what happens when servicing is transferred on loans that have \$0 balance reserves? Will the Enterprises subsidize the new servicer, or the existing servicer for that matter? If so, where will those funds come from? Would that mean additional G-fees or other fees the Enterprises would impose on loan servicers?
- What is the specific “minimum servicing fee” and what is the specific reserve fund amount? Would this amount differ based on loan quality?
- Although not included in the Discussion Paper about the Reserve Account proposal, we believe that bifurcation should be a part of this alternative.

Fee for Service

The Fee for Service plan offers a significant change to the existing structure and an intriguing alternative worthy of additional discussion and exploration. Fee for Service appears to address both financial risks to servicers as well as increased guarantor flexibility, but raises some uncertainty about the TBA market’s reaction to the low servicing fee impact on prepayment speeds and how this might affect liquidity. Further, it’s difficult to understand how Fee for Service materially changes (and may decrease given potential instability caused by reduced servicing cash flows) service to borrowers as compared to the existing system.

In our view, the Fee for Service plan presents a compelling opportunity to substantially simplify the accounting, tax, and risk management associated with traditional mortgage servicing rights (“MSRs”) and more importantly substantially reduces the cash and equity required to retain clients. Particularly appealing is the “Excess IO-Option B¹” that provides a clear distinction between the cash flow related to servicing performing loans vs. the interest only financial instrument embedded in today’s MSRs. Separating the two cash flows into their distinct parts provides originators with more options in secondary market execution. In addition, the significant reduction in capital required to retain mortgage servicing will open the market to smaller originator-servicers, but the relatively small fee for service may promote consolidation or significant outsourcing of the actual

¹ Although presented as an alternative, Excess IO – Option A, fails to fully address the objectives of reducing financial risks to the servicer and somewhat compromises the Enterprises flexibility as guarantor. Option A is a step back toward the existing system, requiring MSR level 3 accounting, MSR hedging and the like. Option B is the far superior alternative.

servicing activity. We believe that a liquid market ultimately develops for an unencumbered Excess IO strip that may lead to enhanced overall value and possibly a reduction in interest rates as the asset becomes efficiently monetized, traded, and financed.

Those originators who desire to retain servicing, but believe that the fee is not adequate to cover their costs have the option to retain some or all of the Excess IO, but with none of the rep and warrant baggage that currently exists. Likewise, the Fee for Service (Option B) proposal enhances GAAP accounting and better matches hedging instruments with real valuation changes as in all likelihood Excess IO strip pricing becomes readily observable vs. the “level 3” mark to model approach used today.

Lastly, bifurcating servicing from origination reps and warrants clarifies the value inherent in the servicing activities, albeit much smaller at the reduced fee, which leads to more certainty, more liquidity, and potentially more stable pricing for the servicing strip itself. Additionally, servicer’s aren’t at risk of the Enterprises transferring an MSR that represents a large portion of their equity. This risk reduction benefit for servicers also benefits Enterprises as they need not worry about the impact of a servicing transfer on their seller and servicers’ balance sheets, thus giving the Enterprises more flexibility to transfer servicing if necessary.

Although the Fee for Service (Option B) presents a number of important benefits, many of which directly address the stated objectives, there are some issues. First, the proposed servicing fee may not provide enough future period cash flow to incent some servicers to invest in their servicing platform or it may not throw off enough cash to cover losses during origination downturns which will lead to added servicer instability. Some servicers may find themselves quickly disinterested in servicing loans, whether in the face of an industry downturn, changes or additions to servicing duties or other unrelated business troubles. Since there will likely be no asset and the actual net positive cash flow and profitability of the servicing activity may be extremely small for some servicers, this may force the Enterprises to subsidize the fee to incent a transfer to a dependable servicer. We would be concerned if this dynamic leads to higher Enterprise fees (G-fee or otherwise) to create such a subsidy; hence, our request to include a thorough discussion of NPL servicing in the compensation discussion. Second, the servicing fee must be large enough so that servicers have the flexibility to exit the servicing business or sell pieces of their portfolio without paying to dispose of it.

We believe that the 6 – 10 basis point range, depending on loan size, generates enough compensation for adequate liquidity.

We also have some important questions to which the answers could significantly change our initial positive reaction toward Fee for Service (Option B). Below is a list of specific questions, concerns or suggestions that we have related to the mechanical aspects of the Fee for Service (Option B) proposal that should be answered and re-circulated for further comment.

- The Fee for Service alternative, similar to our existing method, does not address the issues around NPLs. This directly affects borrower service levels, particularly where service matters most. We understand that servicers will be responsible for collecting and providing loss mitigation on NPLs, but the document hints at additional fees payable to servicers at the Enterprises' discretion. Although we support Enterprise flexibility in this area (after all, they carry risk of loss), we believe that any proposal should include a discussion and description of where those monies will come from since they will no longer be tied directly to the servicing rights. The Fee for Service alternative eliminates the outsized fee that embeds cash flow in our existing MSR structure and without understanding where and how that cash flow will be recouped to cover NPL costs it is difficult to support this alternative.
- How will a reduction in the minimum servicing fee for Enterprise loans impact the current tax safe harbor provision? We are confused about how this important consideration in the proposal cannot be answered by the IRS. Clearly, an elimination or reduction in the tax safe harbor provision would create a net negative economic impact of the Fee for Service method given the originator-servicer retained the Excess IO (whether to subsidize service fee dollars or as a stand-alone investment).
- Consider a fixed basis point servicing fee and avoid the unnecessary complexity of the “basis points for dollars per loan swap” through the Enterprises. In addition to the added complexity, this swap feature exposes servicers to Enterprise credit risk and creates a hidden fee on larger loan sizes to subsidize smaller ones. We propose to simply have the servicing fee as a percent of the loan balance stripped out similar to the mechanism used today. To manage the differences in loan balances, the servicing fee could be set based on 2-3 loan amount tiers (say 6 bpts, 8 bpts and 10 bpts, depending on loan size).

- What exactly is the FHFA’s minimum servicing fee? Is it subject to change? If so, how and when? Does any change impact existing servicing or just new servicing? If the fee for service is based on loan balances, these concerns would largely be self-correcting based on home price changes and the servicing fee tiers. Any dollar per loan fee also needs to include a built-in CPI adjustment factor.
- What are the specific changes to the Enterprise’s minimum net worth requirements under a Fee for Service model? How much is the one-time bi-furcation fee? Many smaller originator-servicers are concerned with how the bifurcation feature as well as how the smaller collateral base of the MSR impacts minimum net worth required by the Enterprises. Clarifying these provisions could garner significant additional support for the Fee for Service approach by smaller market participants.
- What are the specific restrictions for excess IO in any given pool? One of the primary concerns we have is how the Excess IO trades at implementation of a Fee for Service model. Our ability to sell Excess IO to the Enterprises through the traditional Buy-Up programs provides much comfort to support liquidity, but understanding the exact maximum Buy-Up amount is important.
- What does “excessive” prepayment mean? How is it measured? What kinds and how much are the penalty “fees” that the Enterprises impose related to excessive prepayment speeds? Answers to these address one of the critical objectives of the plan which is to continue to promote TBA liquidity. Many of the investors we speak with are concerned about the servicer’s lack of “skin in the game,” but providing clarity around these questions can help allay some of those issues.

Conclusion

While we believe that both the Fee for Service and Reserve Account alternatives address many aspects of the FHFA’s stated objectives, both lack enough clarity to determine if they meet them fully. It is premature to implement any changes until the various servicing standards and initiatives are concluded among the many regulators reviewing servicing requirements. Fully understanding what obligations and what required processes a servicer must perform only makes

sense prior to determining the fees for such services. Further, both plans have a number of unanswered questions regarding mechanics which makes it difficult to reach a conclusion about their adequacy. Most glaring is the lack of discussion and specific proposals about how NPLs affect the compensation framework. Aspects of both plans have merit and we recommend that the FHFA continue the dialogue and debate in hopes that the industry can find a better model than the present one that meets the FHFA's objectives and benefits all mortgage market participants for the long term.

We thank you for this opportunity to comment. Should you have any further questions, please contact Shawn Krause at (313) 373-7773 or at ShawnKrause@quickenloans.com.

A handwritten signature in black ink, appearing to read "William Emerson", with a long horizontal flourish extending to the right.

William Emerson
CEO
Quicken Loans