



December 22, 2011

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

Filed by e-mail: Servicing_Comp_Public_Comments@FHFA.gov

Matter: Alternative Mortgage Servicing Compensation Discussion Paper

Dear Mr. DeMarco:

JPMorgan Chase & Co (“JPMorgan Chase”) is pleased to submit this comment letter in response to the Federal Housing Finance Agency’s alternative mortgage servicing compensation proposals described in releases dated February 2011 and September 27, 2011 (collectively, the “Proposal”). We thank the FHFA for taking the lead to advance the industry’s dialogue on alternatives to the existing mortgage servicing compensation framework.

The Proposal presents two alternatives to the current minimum servicing fee (“MSF”) servicer compensation framework. The first alternative would reduce the current MSF level and provide for a reserve fund (the “Reserve”). The second alternative would fundamentally alter the current servicer compensation framework with a fee-for-service approach. The Proposal, while focused primarily on the servicing of mortgages guaranteed by Fannie Mae and Freddie Mac (collectively, the “GSEs”), will likely influence changes to the mortgage servicing compensation framework for U.S. mortgages in the non-GSE market.

JPMorgan Chase services over 8 million mortgages with an unpaid principal balance of approximately \$900 billion. JPMorgan Chase is the third largest mortgage servicer and the second largest originator of mortgages in the United States. We are committed to thought leadership in the mortgage industry and outstanding service to our mortgage customers.

JPMorgan Chase recommends adopting a reduced MSF approach at 12.5 basis points coupled with a transferable Reserve equal to 3 basis points and an ability to retain float and ancillary income, because it would:

- Level the playing field for servicers of diverse sizes by reducing the magnitude of volatility of the MSF asset and reducing capital requirements, this will encourage more competition in the servicing arena;
- Offer servicers clear incentives to invest in servicing capabilities and build competitive efficiencies to earn back the Reserve, kept as a contingency fee;
- Reduce investor concerns over servicer refinancing churn and faster prepayment speeds;
- Provide servicers a natural and countercyclical hedge to the mortgage credit and production cycles; and
- Help the GSEs preserve servicer counterparty risk management and facilitate servicing transfers.

JPMorgan Chase believes that a compensation framework providing for an MSF of 12.5 basis points and a Reserve of 3 basis points that allows servicers to retain float and ancillary income would be adequate to defray costs through a wide range of credit and production cycles.

The FHFA also could allow servicers to choose between two reduced MSF frameworks, one at 12.5 basis points plus a 3 basis points Reserve and another at 20 basis points plus a 5 basis points Reserve to allow a servicer to reflect the compensation level that best meets its own scale and scope of operations.

Servicing Compensation and Risk Management

Some servicers consider the current MSF framework complex and difficult to manage, and believe that it may have created incentives for some servicers to under-invest in default mortgage servicing. JPMorgan Chase supports measures that would minimize these complexities and the costs of managing a large MSF. The industry would greatly benefit from reducing the size and volatility of the asset created by the current MSF and tailoring it to individual servicer economics.

A reduced MSF and Reserve combination preserves a servicer's incentives to service loans well because the MSF (even if smaller) remains a valuable asset, and the Reserve provides for a significant contingency to be earned. In addition to providing a sound counterparty management tool for the GSEs and investors, the Reserve also encourages liquidity in the mortgage servicing market by promoting a measure of performance transparency and valuable portability.

Changes to the Compensation Framework Should be Coordinated with the Development of Uniform Mortgage Servicing Standards

There is a fundamental principle that holds true for any good or service within any market: a pricing discussion without reference to applicable features and standards is incomplete. While the FHFA considers changes in the mortgage servicing compensation framework, regulators, including the CFPB, are working on developing uniform servicing standards. Accordingly, the FHFA should consider deferring its final review of the servicing compensation framework until uniform mortgage servicing standards are adopted by the industry or their tenor becomes clearer than it is now. JPMorgan Chase recommends that servicing compensation be aligned, to as great an extent as possible, with applicable servicing standards.

The New Servicing Compensation Framework Should Be Designed to Encourage Competition.

Proper management of mortgage servicing demands a strong capital position, liquidity, counterparty protection and regulation. Scale and proper management benefit consumers through lower costs and provide investors with confidence. Within this business context, JPMorgan Chase believes that reducing MSF from the current 25 basis points to 12.5 basis points plus a 3 basis points Reserve would more closely approximate direct servicing costs, decreasing the relative complexity of managing the mortgage servicing business, and thereby fostering increased competition among regulated entities.

Providing an MSF framework that preserves a diverse pool of competitive and profitable servicers and fosters competition should be key goals of FHFA. Mortgage Servicing was highly concentrated before the current crisis, and has been significantly concentrated in its aftermath. A highly concentrated industry generally reduces incentives to compete and constrains investor options. JPMorgan Chase does not believe that this would be a desirable outcome for the mortgage industry

Providing for A Reserve Fund Structure in Addition to a Lower MSF Will Encourage Improvements to Customer Service and Investment in Non-Performing Servicing Capabilities

A lower, servicer-centric MSF coupled with a portable Reserve to support unexpected servicing stresses, or be earned back, would provide servicers incentive to make the appropriate investments in servicing. This would allow for more effective and efficient servicing of both performing and non-performing loans.

Market and other conditions can increase the incidence and severity of defaults, stressing a servicer's cost-to-service non-performing loans. We believe that a Reserve equal to 3 basis points should be sufficient to ensure the availability of adequate funding to handle unexpected servicer costs in a stress scenario. The Reserve would be held in a segregated account identified to cover mortgage losses on a vintage basis. The Reserve would be released only upon specific conditions that would be specifically defined by contracts to be developed in consultation with the industry.

The Reserve would provide more than a source of funds to meet a servicer's unexpected losses. It would also provide servicers, regardless of size, a meaningful performance incentive that could be earned back after a period of years if a servicer properly serviced its mortgage portfolio. In addition, the Reserve, which would relate to specific mortgage loans of a particular vintage, would be portable with both voluntary and involuntary transfers of mortgage servicing relating to such mortgages. Such a portable Reserve would make servicing transfers more attractive to all potential servicers and foster competition among a larger pool of mortgage servicers.

By contrast, the fee-for-service approach would provide little to no incentive for servicers to invest in non-performing loan servicing capabilities. A projected ten dollar per loan per month compensation for servicing performing loans would stop when a loan ceases to perform and would not be recoverable with respect to a prior non-performing period after such loan returns to performing status. Servicers of non-performing loans would be able to collect only "incentive compensation" during such loans' non-performing periods.

Adverse Impact to the TBA Market from a Fee-For-Service Framework

Investors traditionally regard reduced servicing fees adversely. Our research shows that over 70% of investors believe that reducing MSF would have some negative impact on TBA values, with 42% arguing that it would have a 'significant' impact. Historically, mortgage pools with lower servicing fees have exhibited significantly higher prepayment speeds and traded at lower valuations. By providing little or no base servicing fee, investors believe that prepayment speeds may rise significantly more in a fee-for-service framework than under a reduced MSF approach. The US housing market remains fragile at this time. It is critical to preserve the market mechanics that have historically contributed to keeping mortgage rates low. JPMorgan Chase believes that the fee-for-service alternative would alter the current TBA market and lead to unnecessary mortgage rate increases for consumers and a reduction in housing affordability.

In a fee-for-service environment, investors would be more likely to demand higher rates as compensation for the increased risks of loans originated under a fee-for-service model, causing mortgage interest rates to increase overall. A key drawback of the fee-for-service model is that investors regard servicers as lacking "skin in the game" to retain borrowers over a range of scenarios. A fee-for-service framework is more likely to encourage an increase in prepayment speeds as a function of mortgage churn that would result from the quest for origination-related income through refinances of customers with better credit. A faster mortgage prepayment environment would also adversely impact the TBA markets by increasing adverse selection within securitized mortgage pools as better credits are removed upon refinancing, contributing to increased risks to the GSEs and Guarantors, lower investor demand for mortgages and increased interest rates.

JPMorgan Chase believes that investors would regard a fee-for-service framework more negatively than a reduced MSF approach. Potential adverse impacts to the TBA market would be reduced by adopting a compensation framework providing for an MSF of 12.5 basis points and a Reserve of 3 basis points rather than the fee-for-service alternative. The reduced MSF plus reserve framework would retain many of the incentives for the retention of serviced customers that increase the comfort of investors while reducing the complexity of servicing.

A Lower MSF and Reserve Framework Would Better Insulate the Mortgage Industry From an Investor Credit Event

A Reserve asset that a servicer can earn or that a Guarantor can remove (with cause), would more effectively align a servicer's incentives with the Guarantor's interests than would the fee-for-service alternative. In cases requiring a transfer of servicing for cause, the Reserve's portability would facilitate finding a substitute servicer. By enabling investors to provide Reserve compensation to successor servicers, servicing transfers would become more attractive to potential successor servicers. The fee-for-service alternative provides no separately discernible mechanism to make servicing transfers attractive to potential successor servicers likely to face high servicing costs associated with troubled portfolios that probably contain high concentrations of non-performing loans.

Transfer of a Reserve identifiable to a particular servicing portfolio would preserve and, because of its cumulative feature, magnify the benefits of a Reserve: supplemental funds to meet unexpected servicing costs, or become revenue if funds can be released for good performance, thereby increasing the value of a servicing portfolio. None of these benefits exist in a fee-for-service compensation framework.

The lower MSF and Reserve-based mortgage servicing compensation framework will provide investors a natural hedge to a deteriorating credit environment, because foreseeable decreases in mortgage

prepayments will contribute to increase each vintage-specific reserve fund. Compared to a fee-for-service framework, the reduced MSF and Reserve will not contribute to any increase of the current exposure to credit risk.

The Fee-For-Service Approach Would Materially Augment the Role of the GSEs in the Mortgage Market and Increase Systemic Risk in The Overall Economy.

The fee-for-service framework would change the GSEs' role in the secondary mortgage market by directing all mortgage cash flows currently retained by the servicers to the GSEs, and placing the GSEs in the dual and unprecedented roles of master servicer and paying agent to the servicers on three out of every five mortgage loans serviced in the United States. GSEs would also remain as Guarantors on the mortgage-backed securities. To work properly, the fee-for-service alternative would require the GSEs to substantially add staff and invest in the development of new infrastructure to handle their new dual roles. This will add a new layer of operational risk to the GSEs, which are currently under FHFA conservatorship, and expose a large percentage of the U.S. mortgage servicers, investors and consumers to increased GSE-event risk. Such a fundamental change in secondary market dynamics significantly concentrates economic risk in the GSEs at a time when a key objective of the Federal Government is to reduce its footprint in the mortgage market and the potential costs to taxpayers of further government intervention.

The Opportunity to Segregate Excess Servicing and Separate Origination and Servicing Representations and Warranties Would Further Reduce Costs and Facilitate Risk Management

The Proposal presents an important opportunity to improve mortgage pooling economics, servicing rights valuations and manage servicing counterparty risk. The two improvements described below would provide servicers increased management flexibility and reduced risk, resulting in lower rates for consumers.

The first improvement would allow the segregation and trading of excess servicing. Market conditions often result in some small amount of excess spread within a pool over its weighted-average coupon. Rather than rely on the GSE balance sheet to manage this economic feature through buy-ups and buy-downs, segregating servicing into a separately tradable security will improve market transparency, economics and reduce reliance on the GSE's balance sheet. The separation of MSF from consequential excess interest could be done through the issuance of Interest-Only companion tranches that an issuer can hold or sell in its own discretion.

The second improvement would isolate the representations and warranties for mortgage origination, from those for mortgage servicing. Currently, the pool of servicers willing to accept servicing transfers is reduced because potential successor servicers have to assume origination representations and warranties relating to activities that they did not undertake, and that are unrelated to mortgage servicing. Finding a way to separate and price the distinct representations and warranties relating to mortgage origination, from those relating to mortgage servicing, will improve the value of mortgage servicing, promote investments in mortgage servicing to build capacity, and broaden the market for servicing rights.

Conclusion

FHFA should consider aligning applicable mortgage servicing standards with any changes to the current servicer compensation framework to provide appropriate incentives for servicers to invest in loan servicing capabilities. The fee-for-service alternative could discourage servicers from investing in non-performing loan servicing capabilities and pursuing appropriate economies of scale that improve customer-facing technologies. The resulting framework should encourage innovation, and further drive down the costs of servicing both performing and non-performing mortgages.

When coupled with a portable Reserve, a reduced MSF compensation framework would broaden the pool of mortgage servicers through reduced complexity and increased servicer competition. Under a reduced MSF and Reserve compensation framework, the GSEs would benefit from improved counterparty management tools and a broader market for servicing rights. Furthermore, the separation of origination and servicing representations and warranties would fundamentally improve the valuation of mortgage servicing rights, make mortgage servicing more attractive and facilitate servicing transfers.

JPMorgan Chase is pleased to provide you with our comments on the Proposal. If you have any questions concerning this comment letter, or would like to discuss further any of the matters that we have raised, we would welcome the opportunity to continue the dialogue that FHFA so thoughtfully started.

Sincerely,



Jerome A. (Garry) Cipponeri
Senior Vice President