9800 Fredericksburg Road
San Antonio, Texas 78288

December 16, 2011

Mr. Alfred M. Pollard, General Counsel
Federal Housing Finance Agency
1700 G Street, NW, Fourth Floor
Washington, DC 20552
Servicing_Comp_Public_Comments@fhfa.gov

Re: Servicing Compensation Initiative pursuant to FHFA Directive

Dear Mr. Pollard:

USAA Federal Savings Bank (FSB) thanks the Federal Housing Finance Agency (FHFA) for the opportunity to offer public comment on the Alternative Mortgage Servicing Compensation Discussion Paper issued September 27, 2011.

FSB is a federally chartered savings association organized in 1983 to offer personal retail banking services. It is an indirect wholly owned subsidiary of United Services Automobile Association (USAA). USAA is a membership-based association, which, together with its family of companies, serves present and former commissioned and noncommissioned U.S. military officers, enlisted personnel, retired military, and their families. Since its inception in 1922 by a group of U.S. Army officers, USAA has pursued a mission of facilitating the financial security of its members and their families by providing a full range of highly competitive financial products and services, including personal lines of insurance, retail banking, and investment products. Our core values of service, honesty, loyalty, and integrity have enabled us to perform consistently and be a source of stability for our members, even in the midst of the unprecedented financial crisis of recent years.

FSB is a Top-15, national retail originator of mortgages. FSB began servicing loans internally two years ago, and began securitizing loans with Fannie Mae, Freddie Mac, and Ginnie Mae shortly thereafter. FSB is presently the master servicer for over 20,000 loans with a notional balance of approximately $4 billion. In addition, since inception, FSB has originated hundreds of thousands of conforming loans sold servicing-released and subsequently sold to Fannie Mae and Freddie Mac.

FSB chose to begin retaining mortgage servicing rights (MSRs) as a byproduct of offering our members competitively priced mortgages and in order to have additional input regarding our members' servicing experience. We believe this model provides a key benefit to our membership. While the complexity of managing the operations and the financial asset in a servicing-retained model were of concern, we believe that the benefits to our members outweighed the costs.

We offer comments on the following three areas:

1. The merits of a Reserve Account.
2. The merits of a Fee for Service model.
3. The merits of reducing the revenue strip from the present 25 basis points, independent of model.

A. Regarding the proposal to make Modest Changes to the Current Enterprise Servicing Model: Reserve Account

This proposal would replace the current 25 basis points interest-only strip with a 20 basis points strip and a reserve account in which 5 basis points are retained to par for non-performing servicing.

USAA supports this proposal, as it encourages investment in high-touch servicing when delinquencies are elevated, subject to some specific constraints:

A reserve account structure that enables servicers to tap into funds available to support activities related to non-performing loans must avoid the unintended consequence of encouraging or rewarding delinquency. The current model rewards effective underwriting by enabling servicers who originate or select a cleaner book of business to earn a better return on their servicing business.

The reserve account should contain a cap that facilitates release of funds over a period of time.

The reserve account should be maintained by the servicer, not by the agencies in the mortgage backed security (MBS) trust, and must follow the servicing when the asset is sold.

Benefits of this approach are several. It will reduce the capital required to maintain MSR (though by less than the other proposals). It encourages investment in non-performing servicing during times of credit stress, as more resources will be available to servicers through release of the reserves to enable investment in staff, systems, and processes. The practical effect would be to create a synthetic accrual, as expected costs to service non-performing loans would be matched by available reserves.

In addition, a potential separation of the seller and servicer representations and warranties would align well with this approach, as a greater share of the value of the loan would pass to the servicer while the originator would maintain its accountability for originating quality loans.

B. Regarding the proposal to make fundamental changes to the Current Enterprise Servicing Model: Fee for Service

This proposal would replace the present interest-only servicing strip with a monthly fee for service which would be held constant over the life of the loan.

While acknowledging the benefit of matching revenues more closely with costs, USAA prefers the present interest-only compensation structure to the proposed Fee for Service model. The proposal makes the argument that "The value of an MSR is volatile due to the interest-only (IO) nature of servicing compensation." Though the IO structure can be complex to value, the

volatility of the asset is overwhelmingly driven by the borrower's option to prepay without penalty when rates fall. In addition, the volatility of IO cash flow is actually lower than for a fixed fee structure. A Fee for Service cash flow has a longer duration than an IO, because payments are comparatively smaller initially, and larger as the loan ages. A longer-duration cash flow will have higher volatility than a shorter one, all else equal.

USAA understands that structuring the revenue as fee for service may eliminate the need to capitalize an asset, which would be generally positive for the servicer in that capital does not need to be held against the revenue stream. Such a change could enhance competition through lowering barriers to entry. Complicating the issue, however, are several factors. Among them, there would be potential requirements to capitalize the asset if it had been purchased in the secondary market, and by implication the originating servicer would be maintaining an off-balance sheet revenue strip that other market participants are required to capitalize. Another issue relates to originators' potential option to invest their gain on sale in an Interest Only asset, if they believe that is the best use of their capital. Such a proposal fails to consider the tax implications of retaining an IO independent of the servicing Safe Harbor, which reduces the value of the IO relative to servicing. Finally, accounting rules will need further study, to determine if they will still require modeling and valuation of the retained MSR asset or liability.

C. Regarding the proposal to reduce the servicing revenue, for example to $10 per month or to 8 basis points

This proposal reduces the size of the servicing compensation from the current 25 basis points, in order to reduce the size of the MSR retained asset.

USAA supports a servicing revenue interest-only strip between 12.5 and 25 basis points. Economies of scale and efficiency have reduced the operational cost for servicing since the 25 basis point model was first established. Below 12.5 basis points, however, the risk increases that the servicer will be unable to earn a positive return when accounting for all servicing costs. These costs include assuming the operational risk of servicing, owning the repurchase risk, and maintaining adequate resources to fund advances and pool interest, none of which have been included in existing analyses. A hypothetical structure in which the large majority of the revenue is allocated to the marginal cost to service would likely render fewer firms willing to bear the other costs of servicing.

USAA believes that proposals to reduce the servicing revenue strip will definitely benefit the largest lenders, due to the capital relief they will receive from a smaller MSR asset, at little incremental cost. They already have the scale to operate servicing at lower costs than midsize or smaller lenders can, and would likely enable them to virtually double the count of loans they service with a similar capital allocation.

Smaller lenders may benefit as well, but perhaps to a lesser degree, dependent on their perception of the tradeoffs between balance sheet complexity, customer experience, and capital relief. Some lenders may perceive the requirements to manage an MSR asset as a barrier to entry into the servicing business, though others may believe they can earn a positive return under the proposed structure. The likely net effect will be to create advantage for the largest servicers at the expense of smaller ones.

This proposal will also benefit any firm that is considering hedging its retained MSR asset. Some servicers may not be willing, or able, to absorb the cash flow impact of MSR hedging in a declining rate environment, as trading losses are paid today in cash and earned back over the life of the servicing asset. A smaller asset means less volatility and less expense to hedge.

Servicers are going to earn a revenue stream of an uncertain, volatile nature as long as the American mortgage finance industry provides borrowers loans with a prepayment option. That uncertainty is fundamental to the business of lending, however. Capitalizing and managing an MSR asset can enable a bank to earn a positive yield on the asset, net of hedge costs. Institutions that are more effective at managing the risk create a competitive advantage and are able to offer better rates to borrowers.

Other considerations include:

- The proposal could create less room for a high-touch, high-service model, because the revenue will be inadequate to cover the costs. The customer experience will likely be limited to that which is most automated and cheapest to deliver.
- New entrants, or servicing-only providers, will be less likely to invest in servicing, given the smaller revenue stream. If the asset is small or zero, it is not economical to make a capital investment in acquiring the asset. This could potentially dictate that originators will be the only firms willing to service loans, reducing competition and concentrating counterparty risk.
- It is difficult to envision a servicing firm taking over the servicing business of a failed lender when there is less ability to earn a positive return. There would be large risk that insufficient revenue would be available to compensate the servicer for servicing advances and other costs. Such a model would likely leave the agencies or the Federal Government as the only entities willing or able to take on the obligations when a major servicing firm fails.
- At the margin, a smaller servicing asset may impact prepayments somewhat, but the present structure hasn't been a large barrier to refinance activity in both retail and third-party channels. Data indicate that some of the largest servicers have some of the fastest prepayment speeds relative to the industry, suggesting that the investment in the asset does not create barriers to refinance activity.
- Minimizing the size of the MSR asset requires trading the benefit of less volatility on the servicer's balance sheet with the counterparty credit benefit to the agencies.

D. Additional Comments

Any proposals to change the servicing compensation model need to be measured against the goal of aligning incentives between borrower, servicer, and investor. There should also be room to innovate, enabling alternate servicing models to flourish or fail, with mechanisms to facilitate efficient resolution of failed entities.

Transparency in MSR Valuation might make smaller lenders more willing to retain the MSR, but would likely lead to less innovation and investment if the asset became more of a commodity.

The very possibility of earning incremental returns encourages additional participants, enhancing competition and pricing benefits to borrowers.

Bifurcation of the selling and servicing representations would enhance liquidity and transparency in the secondary market for MSR. A net tangible benefit test for refinances also would marginally enhance liquidity by reducing portfolio churn, but implementing such a change must not dramatically increase costs on all originations.

Servicers should be able to halt advances on non-performing loans in some standard fashion nationally, perhaps after 90 or 120 days.

With regard to the proposals to alter the contractual treatment of the Excess MSR, USAA supports Option B in Section VI. B of the proposal. Giving lenders the choice among selling excess via buyup, securitizing it, or booking it as excess MSR, would be beneficial. It is not clear what benefits there are to market participants (other than the agencies) of restricting the circumstances under which the excess may be sold.

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USAA Federal Savings Bank thanks you for the opportunity to provide comment to this thoughtful proposal. We appreciate the FHFA's consideration of our comments and look forward to working with the FHFA in the future. Should you have any questions or wish further clarification or discussion of our points, please contact the undersigned at 210-456-2377.

Sincerely,

James F. Jandrisevits
Vice President