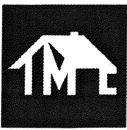

TOWNE
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December 26, 2011

Mr. Edward DeMarco
Acting Director
Federal Housing Finance Agency
1700 G Street NW, 4th Floor
Washington DC 20552
Sent to: Servicing_Comp_Public_Comment@FHFA.gov

Re: Alternative Mortgage Servicing Compensation Discussion Paper dated September 27, 2011

Dear Mr. DeMarco:

Thank you for the opportunity to participate in FHFA meetings on alternatives for a new mortgage servicing compensation structure (introduced in the *"Background and Issues or Consideration"* paper in February 2011 – "Background Paper") and to comment on the resultant "Alternative Mortgage Servicing Compensation Discussion Paper" dated September 27, 2011 ("Discussion Paper").

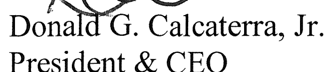
Towne Mortgage Company is a community-focused, privately-held mortgage banker providing mortgage services through partnerships with credit unions, community banks, Realtors, attorneys, non-profits and other community leading organizations. Our emphasis is on strengthening the relationship between homeowners and our partners from loan origination through loan payoff; servicing loans is integral to the value we provide.

The concepts introduced in the Background Paper were new and counterintuitive to us so we engaged with industry associations, accountants, clients, partners and academics to gain insight on the concepts. We shared those perspectives in meeting with the FHFA joint committee members, individually and collectively, and identified numerous areas that required greater consideration before a conclusion could be reached. We are disappointed with the Discussion Paper's rush to change when there remain so many unanswered questions.

We believe any change to the servicing compensation structure threatens the current re-localization of servicing that is improving service to borrowers and will disrupt delivery of loans to the capital markets, increasing costs to borrowers. If a servicing compensation change is needed, we recommend adopting the Ginnie Mae model, a spin off from Fannie Mae that provides a servicing fee range and has remained solvent for decades, including during the recent economic downturn.

The attachment provides comment as requested by the Discussion Paper. We urge you to consider more detailed analysis before committing to change that is inconsistent with the mission and strategic goals of the FHFA, the efforts of the Administration to stabilize the housing market, and the needs of the marketplace.

Sincerely,



Donald G. Calcaterra, Jr.
President & CEO

Discussion Paper Analysis

Evaluation of FHFA's Proposal and Stated Objectives

The FHFA Joint Initiative on mortgage servicing compensation structure ("JI") has requested comments on restructuring the mortgage servicing asset to allow companies to aggregate more mortgage servicing clients with less capital. This will be achieved by lowering the revenue from servicing loans to the level of expense incurred to service loans. The servicing revenue will increase for non-performing loans which incur greater expense.

The JI has requested comments on two proposals - Reserve Account ("Reserve") and Fee for Service ("FFS"). Each of these is discussed within the JI's primary goals and general purpose below.

The JI primary goals are to:

Improve service to borrowers. FFS is silent on this, however the proposal does mention the servicer in the current model *"...is incented to keep loans current, or to restore loans to a performing status, in order to maintain their servicing fee cash flows.*[1] As the first listed of all JI goals, and with substantial conversation on this point in the listening sessions,[2] it appears that FFS, in and of itself, will not improve service to borrowers. In addition, FFS will not pay for servicing a non-performing loan unless successful loss mitigation alternative are achieved and, even then, the fee reduces the longer a servicer works with a borrower. This latter change would likely decrease service to performing loans and non-performing loans not transferred to a specialty servicer with a different revenue structure.

Reduce financial risk to servicers: Increasing servicing costs, Enterprise penalties, and regulatory uncertainty are increasing financial risk to servicers today; the effect of the above, as well as the Basel III capital requirements limiting MSR holdings, are decreasing market payments for servicing rights and associated financial risk to servicers.

FFS proposes to reduce financial risk associated with the MSR payment by eliminating the financial value of MSRs (setting servicing revenue at expected servicing costs). Removing profits from the MSR is risky, however, as it reduces buyers to only those who value relationships, rather than buyers interested in a return on investment from the financial asset.

In addition, the reduced revenues will not provide for unexpected future servicing costs or servicing of NPLs that do not earn an incentive fee; that would result in a liability to provide for anticipated expenses in excess of revenues. Given the uncertainty, services will likely be required to establish reserves for losses, adhere to increased net worth requirements, and pledge cash accounts to protect the Enterprises. All of these increase financial risk.

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[1] Discussion Paper, page 7, first paragraph
[2] Ibid, page 16, opening paragraph

FFS transfers the servicing right to the Enterprise to act as a Master Servicer:[3] the servicer receives a fee to cover cost of servicing performing loans while the servicer incurs the cost of servicing NPLs with only a possibility of expense reimbursement. The cash flow change of receiving payment from Fannie monthly versus taking the servicing fee out of borrower payments as received increases financial risk to servicers.

Provide flexibility for guarantors to better manage non-performing loans ("NPLs"), while promoting continued liquidity in the To Be Announced (TBA) mortgage securities market.
The Enterprises are the guarantor in the current and proposed structures. The current structure provides sufficient cash flow to ensure proper management of non-performing loans and the guarantors have sufficient leverage to effect proper servicing of NPLs (as evidenced by penalties which are changing mega-servicer behavior and feedback from housing counselors that interactions with the mega-servicers has improved dramatically).

FFS transfers the revenue to pay NPL servicing to the Enterprises thereby removing any incentive for the servicer to keep loans current. The lack of investment in MSRs increases the risk the servicer might walk away from a servicing portfolio, leaving the Enterprise with the task, and cost, of moving the servicing.

The general purpose of the JI is to:

Explore a number of issues that have been the topic of industry debate and discussion over the years;
Alternatives to the current mortgage servicing compensation model have been discussed only among a small group of individuals, primarily within the Enterprises and top servicers, prior to the release of the Background Paper in February 2011. The topic has not been the subject of presentations at any notable MBA, ABA, ICBA, CMBP, NCUA, NAR, or CRL[4] events until after February 2011. Even now, the vast majority of industry participants remain uninformed on the subject.

To suggest that these concepts have had any significant discussion, not to mention years of conversation, among consumers and industry groups, is reflective of the composition of the JI committee. The JI needs to include experts from disciplines other than capital markets, legal, and accounting in order to obtain the information needed to make a fully informed, prudent decision.

Evaluate the potential impact on industry participants of alternative compensation structures;
The analysis was exclusively on the structure of the servicing asset and management of extremely large MSR assets. There were no working groups comprised of representatives from lenders, bankers, consumers, Realtors, SIFMA[5], etc. that jointly studied the proposals. There was not time for the effected industry participants to come to a consensus on moving forward.

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[3] Ibid, Page 24, Master Servicer box

[4] MBA – Mortgage Bankers Association of America; ABA – American Bankers Association; ICBA – Independent Community Bankers Association; CMBP – Community Mortgage Bankers Project; NCUA – National Credit Union Association; NAR – National Association of Realtors; CRL – Center for Responsible Lending

[5] Securities Industry and Financial Markets Association

Submit possible solution for public consideration.
Numerous alternatives were proposed in meeting and formally in writing, however, the JI limited the Discussion Paper to two alternatives which exclude the current and Ginnie Mae structures. In the end, the Discussion Paper rarely deviates from the Background Paper, suggesting that the listening tour yielded little value to the JI.

FHFA Strategic Plan Considerations

The FHFA strategic plan cites stabilizing the mortgage market 11 times in the first 8 pages - all before listing its strategic goals. The FFS proposal is presented as "fundamental" change. Fundamental change without certainty does not provide market stability, it decreases it.

The plan has three strategic goals. The first is safety and soundness of the Enterprises. In order to achieve this, the Enterprises will need to ensure it has sufficient revenues to cover expenses, including loan losses and servicing costs.

Removing profits form the servicing asset based on expected servicing expense levels (necessary to avoid capitalizing the asset) means unexpected increases in the cost of servicing will have to come from the Enterprise reserve. This assumes the Enterprise will be around, will properly manage the reserve, and that the reserve will be sufficient to cover unexpected increases in servicing costs which includes compensatory fees and servicing of non-performing loans on which incentive fees are not earned. It will also have to include cost of transitioning portfolios from servicers who walk away. Unlike the current situation where a servicer closing down has to find a buyer or walk away from net worth, the new model allows a servicer to withdraw tangible net worth and lock the doors. The Enterprise then needs to move the portfolio to a new servicer. If the market cost at the time is $12/loan/month or the portfolio is delinquent, the cost to Fannie will be greater than $10/month/performing loan; Fannie will have to pay $12 for performing loans and more for the delinquent loans.

Bifurcating reps and warranties will require making sure the seller is collectible to ensure safety and soundness of the Enterprises. Fannie's current bifurcation program requires $15 million in net worth. It is logical, therefore, to expect the first step will be to increase net worth - but that does not prevent a company from withdrawing the net worth and closing down (same as with inverted servicing profits note above).

In order to ensure safety and soundness of the Enterprises, FHFA will mandate that they require pledged cash accounts from sellers. We see it in place now and it is the only way to protect the Enterprises from seller liquidation.

The second strategic goal is to support a stable, liquid and efficient mortgage market including sustainable homeownership and affordable housing. The FHFA proposal is moot on this point for either option, but the dramatic changes to the servicing structure in FFS will change the profile of servicers and so FHFA has a responsibility to ensure FFS achieve this goal and details such before soliciting support for a change.

If we look at industry data to assess the impact of increasing required net worth for seller/servicers, we see that service to borrowers will have to improve through a dramatically smaller population of eligible servicers. FDIC data shows 45% of banks with net worth over $2.5 million (current Fannie required net worth) could not meet a $15 million net worth requirement[6]. The number is even higher for credit unions, 73%[7]. We do not have data on Enterprise lenders or private lenders, but our guess is it isn't any better.

So while the proposal fails to demonstrate how either option will help it meet the second strategic goal, we do know that FFS will have to do so with dramatically fewer sellers/servicers in order to achieve FHFA's first strategic goal.

FHFA's third strategic goal is to preserve and conserve the assets and property of the Enterprises, ensure focus on their housing mission, and facilitate their financial stability and emergence from conservatorship. The proposal fails to detail how the first two legs of this goal are achieved, but I think a strong argument can be made that moving the servicing asset to the Enterprises will facilitate its financial stability; especially given the Enterprises can determine how much it wants to pay from the reserve unilaterally. There remains a risk, however, that servicers will walk away without an investment in a servicing asset.

Additional Questions from meeting with FHFA requested to be put into our comment letter

1. Can we get sensitivity analyses that assess the impact of increased servicing costs and varying delinquency percentages on serving asset/liability calculation, minimum net worth and required cash collateral?

2. Can we get Feedback from Fannie Mae default, loss MIT and SAI areas on impact of changes in those areas and related costs to perform or monitor servicer performance?

3. Without an investment in a servicing asset, a seller/servicer can generate a significant amount of low quality loans, taking the money up front and closing down just as things start to go bad. The guarantee fee and NPL reserve are accumulated over time and will not be sufficient to cover early payment default servicing or losses and there will not be any pledged collateral or net worth to cover the losses. We assume the minimum net worth for reduced servicing fee (FFS or low bps) will be comparable to the $15 million currently required to bifurcate rep and warrant under the co-issue program. How will the minimum be increased based on volume and servicing portfolio size?

4. The $10/month fee in the proposal was derived from three sources:
    a. Can you provide the three sources?
    b. Did the source use historical or current cost figures?
    c. Did the source include the current servicing requirements?
    d. Did the source include a repurchase reserve?
    e. Did the source include the cost of compensatory fees?

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[6] 9/30/11 FDIC data
[7] 3/31/11 NCUA data

f. What costs were included for servicing NPLs that do not achieve an incentive payment?

5. Under the current structure, the servicer collects the payment, keeps it servicing fee, pays the Enterprise its guarantee fee and sends the remainder to the investor. Under FFS, the Enterprise will own the servicing asset; so will the cash flow from the servicer to the Enterprise and then back to the servicer? Will the Enterprise have the right of offset to take fees it deems due (i.e. compensatory fees, DU fees, repurchase costs) before sending the monthly servicing fees to the servicer?

6. It appears that specialty servicing firm practices were used for development of delinquent servicing required activities, but not specialty firm compensation structures. Can you share how this decision was made?

Response to Questions Posed in the Discussion Paper:

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

Origination and Servicing Markets
Without the additional information noted as missing above, it is hard to determine the impact with any certainty, however, both would reduce the number of aggregators and servicers and therefore would have a negative impact on the pricing obtained by sellers.

The type of servicer will change under FFS where greater volumes are needed to achieve the economies of scale to act as a payment processor. There will likely be different, but significantly fewer, servicers and they would be technology and marketing driven. Get ready for monthly statements that look like Nascars.

Service to borrowers.

Customer service will be highly automated with contact, not quality, increasing under either structure. It will be more pronounced under FFS. Payment processing is not customer service, but the emphasis on marketing and technology will drive the servicing solution.

No one likes a call center, not even those who work in them. Bringing target marketing to servicing will bring greater segregation of clients with those presenting the most value, treated the best. Highly marketable borrowers will receive direct lines to live operators while less desirable borrowers will be directed to web sites and on-line chat support.

Those not able to operate in the digital world (elderly, less educated, immigrants) may slip into an NPL status before receiving the contact they need.

Continued cost increased will force companies to outsource overseas.

Efficiency in the secondary market
It is too early to tell. I understand the market does not have an execution for the FFS so we have to wait for that to evolve. The reduction in servicing fee will not have a convulsive effect like FFS.

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

We like the ability to defer taxes and it provide greater income when the market pays less than the economic value like it is now. For us, having the servicing income to cover cost and provide a return, without having to pay too much for it, allows us to service our clients from loan closing to payoff without concern that costs will rise to exceed revenues.

a) Does the capitalized MSR impede competition in the servicing and origination market?
No, overpaying for the MSR does. MSRs are an investment just like any other investment and those that manage them can produce a satisfactory return.
b) Does the impact vary across various business and interest rate cycles?
Yes. Servicing provides cash flow when production is low and allows us to maintain a consistent service level and retain our key production people. When the competition for MSRs become too great, we sell servicing, but it eventually become rational and we retain the MSRS.
c) Does the impact vary across size of servicers and originators?
Probably; you need to compare the responses to determine.
d) Would greater transparency in MSR valuations improve the competitive landscape?
Greater transparency with guarantee fees, buy up grids, and counter party risk assessment would improve the competitive landscape by providing a level playing field among all seller/servicers; it is the cost of the MSR, not the capitalization, that has the greatest impact on how we operate.
e) What is the impact of a potential reduction in the tax Safe Harbor?
The impact will be negative and limit our desire to service. Part of the attraction of retaining servicing is its simplicity (yea, it is not as hard as it is being made). When you pay taxes before receiving cash, need accounting and tax expertise to monitor the process and have to use cash to do so, the return drops - precipitously for small companies. Tax it, complicate it and you reduce its value to all but the largest servicers.

f) Should the servicer be required to hold a capitalized MSR asset (effectively be an IO investor) as a condition of performing servicing activities?
No. The servicer should be required to retain a servicing fee that represents a cash flow it would not want to walk away from, that will incent the servicer to make sure payments are collected and borrowers remain current. Whether that servicing fee is capitalized or not is a matter of accounting, whether it is taxed is a matter for the IRS, but the servicing fee should never be set so low that the servicer doesn't hesitate to abandon it. Capitalization issues result from paying more for an asset than you can put on your books. People who do that should not be allowed to service if they complain.

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)?
The I/O strip should remain attached as the extent to which the MSR is an I/O strip depends on the cost to service and varies by servicer. I do not have the size or the internal expertise to buy and sell I/O strips and cannot comment further.

4. Should these proposals encourage greater investment in non-performing loans operations or abilities in a benign market cycle?

Not these proposals. The proposals only discuss the impact of splitting the MSR and focus mostly on Basel III and developing a new loan-level market for I/O strips. We do not know the extent of servicing requirements to be performed but it is highly likely that things will change again once we get through the backlog of delinquent loans and into servicing the high quality loan being produced today.

a) How does this impact the alignment between guarantor and servicer interests?
FFS makes the Enterprise the master servicer who controls servicing cash flow, making the servicer a vendor who receives a fee for providing a service. The servicer is no longer an investor in servicing rights as it is paid the cost for servicing a loan.
b) Would this improve service to borrowers?
Less so under Reserve, no under FFS; eliminating the servicer's vested interest in the servicing asset will not compel the servicer to improve service. The more active role of the guarantor to prod the servicer to improve service will add a layer of cost not in the current structure which the borrower will pay for. The current system is incentive based; the proposed system requires a hammer.

5. What would be the impact of the proposal on the TBA market if there were no MSR capitalization?

It does not matter if the MSR is capitalized; it matters if it has value. If there is value, the holder will want to keep it and be less likely to write a loan above market and then immediately refinance it.

a) To what degree might the net tangible benefit test and other suggested provisions help mitigate any potential negative impact on the TBA market?
Minor. It is applied after the fact. Who is checking before the MBS is sold?
b) What additional steps can we take to assure continued liquidity in the TBA market?
Assure the market that any changes to the servicing compensation structure will not be adopted. The market needs stability, not fundamental change.

6. Should any of the following provisions that were proposed in the fee for service proposal be considered independent of any other changes to the servicing compensation structure?

a) Bifurcation of selling and servicing representations and warranties.
The Fannie program should be expanded with transparency.
b) A net tangible benefit test for streamline refinances.
No. Lowering the payment improves the borrower position and reduces likelihood of default. Managing losses is often about enticing people to pay their loan. Make it less expensive to stay in a home than to rent and people will remain underwater. The opposite is not as true.
c) Restriction of the amount of excess IO in a given pool.
No.
d) Limitation of P&I Advance requirement
Yes, as a non-depository institution, our cost of capital is high. The actions of regulators and the Enterprises have driven away lenders who used to accept servicing as collateral.
e) Flexibility for excess IO execution.
No value here for us. If FFS is adopted we will not be able to service Enterprise loans.

General Comments

- The existing servicing compensation structure - in which the servicers are incented to keep loans current, or to restore loans to a performing status, in order to maintain their servicing fee cash flows - provides stability to a still fragile mortgage market.
- The proposal fails to state a benefit to consumers while reducing the revenue servicers will have to serve borrowers.

- Bifurcation of reps and warranties can occur under either proposal; however, it is required to FFS viable. It will greatly reduce the population of companies that can sell and/or service for the Enterprises, reducing consumer options and increasing servicing concentration.
- The volatility of the mortgage servicing rights asset (MSR) and Basel III capital treatment of MSRs are reducing payments for MSRs down to a more realistic and manageable level, prompting more servicer to enter the market.
- Processing a payment is not customer service. Treating performing servicing like payment processing will increase non-performing loans as borrowers struggle to talk to someone until a loan is not performing. No one likes a call center.
- FFS will increase instability as we wait for its required new markets to emerge: new MBS structure, a transactional IO strip market, no/low profit servicers, etc.
- The "fundamental" change proposed by FFS is not consistent with the FHFA mission to support a stable and liquid mortgage market,[8] fails to meet FHFA's commitment to work with other regulatory agencies,[9] and frustrates the simultaneous achievement of its three strategic goals.
- Reducing revenue to historical costs in a market with undefined and unknown future costs is not fiscally sound.
- The proposals are inconsistent with the Administration's and Congress' stated goals for the Enterprises.
- The proposal's reason for discounting the Ginnie Mae model as a solution is invalid. Ginnie was part of Fannie Mae until 1968.[10] Fannie could operate without risk to its safety and soundness and better serve homeowners if its operations were structures like Ginnie Mae

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[8] Federal Housing Finance Agency Strategic Plan 2009-2014, page 1
[9] Ibid, page 10
[10] Fannie Mae Charter Act, preface