December 21, 2011

Mr. Edward DeMarco

Acting Director

Federal Housing Finance Agency

1700 G Street, NW 4th Floor   
Washington, DC 20552

Re: Comments to Joint Initiative on Alternative Mortgage Servicing Compensation

Dear Mr. DeMarco:

This letter is in response to your request for public comment regarding alternative servicing compensation proposals set forth in the Federal Housing Finance Agency’s recently issued discussion paper titled “Alternative Mortgage Servicing Compensation.”

Background

On September 27, 2011, the Federal Housing Finance Agency (“FHFA”) issued a discussion paper in order to seek public comment on two proposals for new servicer compensation structures. The FHFA’s stated objectives in proposing new servicing compensation structures are to:

* Improve service to borrowers;
* Reduce financial risk to servicers; and
* Provide flexibility for guarantors to better manage non-performing loans, while promoting liquidity in the TBA market.

Some of the issues that FHFA attempts to positively address with its proposed alternative mortgage compensation structures include:

* Enhancing competition for originations and servicing;
* The impact of mortgage servicing compensation on the broader housing and mortgage market;
* The volatility of the value of mortgage servicing rights (“MSRs”)
* The capital intensive nature of MSRs, including the potential impact of Basel III;
* The lack of transparency in MSR valuation; and
* The potential for industry consolidation under the existing compensation structure, thereby leaving the GSE’s with concentrated risks to large servicers.

Alternative Mortgage Servicing Compensation Proposals

In response to the recent housing and mortgage crisis, and various government programs intended to benefit delinquent and defaulting borrowers, and in an attempt to address issues relating to servicing defaulted loans under the current enterprise compensation model, FHFA proposed two alternative compensation models for consideration. These models are as follows:

1. Reserve Account Model

The first alternative proposed by the FHFA represents a change to the current compensation structure and is similar to the compensation structure proposed individually by both the Mortgage Bankers Association (“MBA”) and the Clearing House Group (“Clearing House”). This proposal leaves most of the current compensation structure in place but would reallocate a portion of the minimum servicing fee to pay for non-performing loan servicing, which would be held in a reserve account. If the reallocated funds were not required to be allocated to non-performing servicing costs, at some point the funds would be released to the servicer. Under the Clearing House proposal the base servicing fee would be 12.5 basis points with a reserve of 3 basis points. The MBA proposal suggests a base servicing fee of 20 basis points with 5 basis points allocated to the reserve.

1. Fixed Fee Per Loan Model

The FHFA also proposed a fixed fee per loan model. Under this proposal, the guarantor would pay a fixed fee for each loan to the servicer. FHFA uses a hypothetical fee of $10 per month for purposes of discussion. The fee would be funded through collection of a master servicing strip by the guarantor. The servicer could continue to retain excess servicing or sell it in the form of a buy up at sale or in a subsequent sale. Guarantors could then be free to negotiate higher fees with servicers for non-performing loans. Selling and servicing reps would be bifurcated. Excess servicing could either be tied to the MSR as in the current model or the excess servicing would be contractually separated from the MSR. If separated from the MSR, the excess servicing piece could be sold to third parties after sale to the GSE’s and it would not automatically transfer with the MSR.

In order to address bond market considerations, the GSE’s would implement certain restrictions on streamline refinances, enhance monitoring and tracking of individual servicer prepayment speeds, and restrict the amount of excess servicing in each pool.

A comparison of the current servicing compensation model and the two alternative models proposed by the FHFA is as follows:

Comparison of Alternative Proposals

|  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- |
|  |  |  | | Current Model | Reserve Model | Fixed Fee Per Loan Model |
|  |  |  | |  |  |  |
| Minimum Service Fee | |  | | 0.25% | 0.20% or 0.125% (with 5 and 3 bps, respectively held as reserve) | Flat fee per month ( $10 in FHFA example, possible higher fee for NPL) |
|  |  |  | |  |  |  |
| Excess servicing | |  | | Integrated with MSRs; can only be sold after securitization with GSE approval | No Change | Asset separate from MSR; possibly permitted to be sold at any time |
|  |  |  | |  |  |  |
| Reps and Warranties | |  | | Origination reps follow servicing | No change | Servicing and origination reps bifurcated |
|  |  |  | |  |  |  |
| Ancillary income | |  | | Servicer | No change | No change |
|  |  |  | |  |  |  |
| Compensating interest cost | |  | | Servicer | No change | No Change |
|  |  |  | |  |  |  |
| Advances |  |  | | Servicer | No change | No change |
|  |  |  | |  |  |  |
| Tax Safe Harbor | |  | | Likely preserved | Likely preserved | Unknown |
|  | |  | |  |  |  |
| Hedging Exposure | |  | | Significant | Minimal Change | Less exposure, but likely still a risk asset |
|  | |  | |  |  |  |
| Natural Hedge | |  | | Preserved | Preserved | Materially curtailed |
|  | | |  | |  |  |
| Capital requirements ( bank ) | | | Increase due to Basil III | | No change | Likely lower based on lower fees |

AHMSI’s General Comments

AHMSI notes that the MBA (of which AHMSI is a member) has formally responded to the FHFA’s Discussion Paper in a letter dated December 8, 2011 (the “MBA Response Letter”). AHMSI generally supports and affirms the MBA’s comments set forth in the MBA Response Letter with one noted exception: the normal servicing fee should not be lower than 20 basis points with a reserve of 5 basis points.

AHMSI’s view is that a minimum servicing fee of less than 20 basis points will only serve to further consolidate the already shrinking servicing industry in the hands of large bank servicers. The 12.5 basis point compensation model was proposed by the Clearing House which is a trade association that represents large bank servicers. A 12.5 basis point minimum servicing fee would require lower MSR capitalization which would benefit large bank servicers who will be subject to Basel III. In addition, the reduction of the minimum servicing fee from 25 basis points to 12.5 basis points would benefit large bank servicers with large servicing platforms and economies of scale and FDIC-backed deposit based financing, thus prohibiting small-to-midsize servicers from entering the industry or even continuing to service loans for the GSEs for reasons of cost and profitability. Allowing the largest servicers to continue to aggressively aquire greater amounts of servicing will drive relative profitability down. Thus, we believe the 12.5 basis point minimum servicing fee would result in further consolidation of the servicing industry which is contrary to one of the express goals of FHFA in proposing alternative compensation structures.

Additional Comments

AHMSI appreciates and supports FHFA’s mission and goals. However, we strongly believe that a fixed fee per loan model falls well short of achieving almost all of the goals that FHFA is attempting to achieve through changing the compensation structure. In our view, the fixed fee per loan model fails to demonstrate conclusively that the proposal will benefit borrowers or will reduce consolidation. In fact, many elements of the fixed fee per loan model will have the opposite impact:

* The fixed fee per loan model would reduce the need for the large bank servicers to divest due to lower capital requirements but would still allow them to reap the benefits of significant scale, thereby potentially exacerbating the servicer concentration issue;
* A low monthly flat fee that is fixed will encourage servicers to minimize servicing costs particularly after a rep and warrant modification, which would reduce a servicer’s incentive to keep a loan current, and thereby potentially increase the cost of mortgage credit;
* The bond market may discount the MBS relative to existing practice due to the lower fee despite proposed rule changes, making mortgage credit more costly;
* The natural hedge of origination business cycles with servicing would largely be eliminated for small originators thereby leading to increased cash flow volatility. The contention that material excess servicing holdings can compensate for the elimination of the servicing fee as a business cycle hedge is a potentially costly proposition for small and non-bank servicers that rely on the tax safe harbor to reduce capital requirements related to the MSR. If the tax safe harbor were eliminated or reduced, many servicers would not be able to meet return and capital hurdles by substituting excess servicing; and
* The GSEs would likely make modifications to originator and servicer net worth standards as the result of mandatory bifurcation and servicing fee reduction, which may lead to a contraction in the small seller universe.

In a recent webinar, the FHFA stressed that one of the primary objectives of the fixed fee per loan model is to reduce servicing earnings volatility associated with the MSR asset. FHFA views the skills and knowledge required to effectively hedge the MSR asset to be outside the core competency of most servicers. The FHFA also stressed that a change in the compensation model to a fixed fee per loan model does not change the overall servicing compensation from the current enterprise model since an IO strip will be available to hold or monetize at the servicer’s election.

AHMSI disagrees with the FHFA’s assessment for a number of reasons. First, many small servicers use the MSR cash flows as a natural business cycle hedge. Second, the skills and knowledge to hedge the MSR asset are readily available. Most larger servicers already have this skill set internally or outsource this function to experts. Most servicers have MSR hedge programs in place and have had such programs for a number of years. We believe that the issue with the current model is the concentration of risk in amounts greater than the origination capacity would warrant at the large bank servicers. This concentration was facilitated in part by guarantee differentials creating economic incentives for the creation of a small group of large aggregators. New capital standards ( i.e. Basel III ), flattening of guarantee fees, and perhaps new rules on concentration of risk would be effective tools to facilitate a de-consolidation of MSR risk. Although the MSR asset is indeed volatile, most servicers have been able to manage volatility to reasonable levels. In addition, the IO strip that the FHFA proposes servicers retain or sell under fixed fee per loan model exhibits some of the same volatility as the MSR asset. Third, the combination of the fixed fee per loan, together with the potential yield of the monetized IO strip may not necessarily result in the same overall compensation. The proposed fixed fee of $10 per loan per month may be not be sufficient to allow small-to-mid-sized servicers to generate sufficient profit to stay in the business. Therefore, the combination of the IO strip of diminished value and the insufficient fixed fee will likely result in less overall compensation to the servicer than the current model. The probable result of this will be to force small servicers to exit the industry, thereby ensuring further consolidation.

AHMSI supports other ancillary elements of the FHFA’s flat fee proposal. We do not believe that there is a linkage to one compensation proposal or the other. Each, in our view, should be considered on its own merits.

Bifurcation of origination and servicing representations and warranties is one element of FHFA’s proposal that AHSMI views favorably. A principal issue constraining liquidity in the MSR market today is the assumption of origination representations and warranties by the non-originating servicer, and the GSE’s first right of offset against any funds due from the servicers to a the GSE. These considerations have led to a marked reduction in the secondary market for MSRs and extraordinary constraints on the financeability of the MSR asset. These constraints have had a severe impact on the non-bank servicers, which must rely on third party financing or equity. Ironically, the constraints themselves impair the collateral value of the MSRs to the GSEs. Increasing liquidity will ultimately aid the deconsolidation objective by allowing greater financing opportunities to servicers, who have been historically disadvantaged. In addition, fairness should dictate that a fully-approved and vetted originator should be responsible for its own actions, and an innocent subsequent holder of the MSR should not be forced to be a guarantor of transactions to which it was not a party.

The separation of the excess servicing from the MSR is appropriate and overdue. AHMSI believes that all cash flows in excess of the required minimum servicing fee should be eligible for securitization. This treatment should not be something reserved for only the largest servicers on a negotiated basis. This simple step will increase liquidity and financing options while providing benefit to the borrower by allowing originators to price the loan to the highest and best execution.

Therefore, we encourage FHFA to consider the bifurcation of origination representations and warranties and separation of the excess servicing from the MSR regardless of which servicing compensation model is adopted.

AHMSI believes that preservation and enhancement of the current model is the best means to create a natural deconsolidation and to provide originators/servicers with adequate returns, thereby ultimately benefitting the borrower through sustainable businesses in a competitive environment. For the reasons outlined above, AHMSI fully supports and endorses the maintenance of the current servicing compensation model. If FHFA elects to change the compensation model, AHMSI recommends that any changes to the compensation model be limited to the MBA’s original proposal of 20 basis points minimum servicing fee with 5 basis points of reserve.

AHMSI appreciates the opportunity to comment on FHFA’s alternative servicing compensation models. Please contact me directly with any questions or comments.

Very truly yours,

Barry J. Bier

Executive Vice President

Cc: D. Applegate

J. Dorchuck, Esq.

J. Davis

B. Bowen, Esq.