

# Servicing Compensation Initiative

pursuant to

FHFA Directive in Coordination with HUD

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MBA Conference Panel Discussion

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**Disclaimer:** This presentation, compiled at the direction of the Federal Housing Finance Agency (FHFA), illustrates potential alternative servicing models. The information and illustrative examples provided in this presentation are intended for discussion purposes only and are based on a number of assumptions such as IO valuation multiples, net float/ancillary values and net costs to originate; they do not reflect any decisions regarding an alternative servicing model or a guarantee of future outcomes to the extent an alternative servicing model is implemented in the future. The information and illustrative examples are not to be taken as accounting or tax advice or conclusions.

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# Joint Initiative Background & Objectives

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- ❑ On January 18, 2011, FHFA announced a Joint Initiative to consider alternatives for a new mortgage servicing compensation structure
- ❑ The Joint Initiative's primary objectives were:
  - ❑ Improve service for borrowers;
  - ❑ Reduce financial risk to servicers; and
  - ❑ Providing flexibility for guarantors to better manage non-performing loans, while promoting continued liquidity in the To Be Announced (TBA) mortgage securities market
- ❑ In addition to these primary objectives, the Joint Initiative has been broadly guided by other goals, such as evaluating whether changes in servicing compensation could lead to enhanced competition in the market for originations and servicing
- ❑ To promote an informed discussion of pertinent issues, FHFA posted an *Issues and Background* document in February 2011. FHFA also sponsored a series of listening sessions with interested stakeholders, including mortgage industry participants, consumer advocates, research analysts, trade associations, and federal and state regulatory agencies.
- ❑ Based on the input received from the public, the Joint Initiative developed and debated several concept proposals. Two such proposals were released in a discussion document in September 2011, and FHFA is requesting public comments for a 90-day period. Comments may be submitted to FHFA at [Servicing\\_Comp\\_Public\\_Comments@fhfa.gov](mailto:Servicing_Comp_Public_Comments@fhfa.gov).

# Reasons for Considering Change

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- ❑ Developing a more robust mortgage servicing model is in the interest of the guarantors, FHFA, and the overall mortgage market.
- ❑ The servicing industry has become increasingly consolidated, which leads to problems from the guarantors' perspective in terms of managing servicer performance and counterparty risk.
- ❑ Part of the problems in mortgage servicing may be related to compensation structure
  - ❑ Mis-alignment of incentives with income when the loan is performing, but no income when non-performing, has led in some instances to suboptimal servicer performance and a lack of focus on dealing with non-performing loans.
  - ❑ The creation of a capitalized MSR asset may have contributed to consolidation in the mortgage servicing industry. The issues highlighted with this asset over the years have included:
    - ❑ Volatile MSR returns, with imperfect and sometimes prohibitively costly hedges
    - ❑ A capital intensive MSR asset, requiring approximately 17% bank regulatory capital, which may be potentially exacerbated under Basel III
    - ❑ Level 3 asset valuation of the MSR lacking valuation transparency
    - ❑ Exits from the mortgage business prompted by capital intensive investment and volatile returns, leaving the Enterprises with concentrated risk of large servicer default

# Joint Initiative Public Feedback

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- ❑ **Feedback centered on several general issues, summarized below:**
  - ❑ A substantial number of participants expressed concerns over the fragile state of the housing market, and concerns that a change in the manner in which servicers are compensated would further complicate an uncertain landscape
  - ❑ A substantial number of participants expressed concerns over the potential impact on the TBA market of changes in the 25 basis point MSF
  - ❑ A substantial number of participants expressed concerns that certain changes in the mortgage servicing compensation structure—specifically, a reduced MSF—would result in further consolidation in the servicing industry. They feared that servicers without significant economies of scale would suffer if the servicing fee were significantly reduced
  - ❑ Participants were virtually uniform in their support for bifurcating the selling and servicing representations and warranties. According to these participants, the inability to split representations and warranties is a hurdle to transfers of servicing portfolios.

# Joint Initiative Public Feedback

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- ❑ **Feedback centered on several general issues, summarized below:**
  - ❑ Participant views on holding a capitalized MSR asset were not uniform. Many participants viewed a capitalized MSR as an important component of their business model . Some participants viewed a capitalized MSR asset as contributing to earnings volatility and subject to capital constraints, which reduces their desire to be active in the servicing market.
  - ❑ Consumer groups expressed concern that—post crisis—frequent servicing transfers led to borrower confusion. Their feedback was utilized to eliminate structures that would call for the frequent transfer of loans.
  - ❑ Investor comments included concerns about the integrity of the TBA market and whether a new structure would encourage an increase in pre-payment speeds. Investors suggested this risk could be mitigated by imposing requirements regarding modifications. The white paper proposes alternatives in this area.

## Proposal: Reserve Accounts (MBA & Clearing House)

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- ❑ Servicers would retain a reduced MSF strip (ranging from 12.5 to 20 basis points)
  
- ❑ The reserve account would “kick-in” after pre-determined thresholds are met
  - ❑ Predetermined servicer performance targets could help negate the need for the reserve account could lead to a partial or full refund of the reserve account to the servicer
  - ❑ The triggers are not currently defined, but could include geography-based market conditions, time periods, performance measures, etc.
  - ❑ Each servicer would have its own reserve account related to its loans; there would be no cross-collateralization among servicers’ reserve accounts.
  
- ❑ The reserve account would move with any transfer of servicing
  
- ❑ The reserve account would be subject to the rights of the Enterprise in the event of servicing seizures, written into the Enterprises’ Servicing Guides
  
- ❑ Selling representations and warranties would be held by the servicer, as they are today, and would transfer with the servicing to the new servicer.
  
- ❑ The servicer bears the risk that the MSF and the reserve account are insufficient to cover the servicer’s costs.
  
- ❑ The structure will allow for a MSF that would provide a means to accommodate regulatory changes to servicing requirements.
  
- ❑ The structure does not substantially change the nature of the treatment or execution of excess IO from today’s model

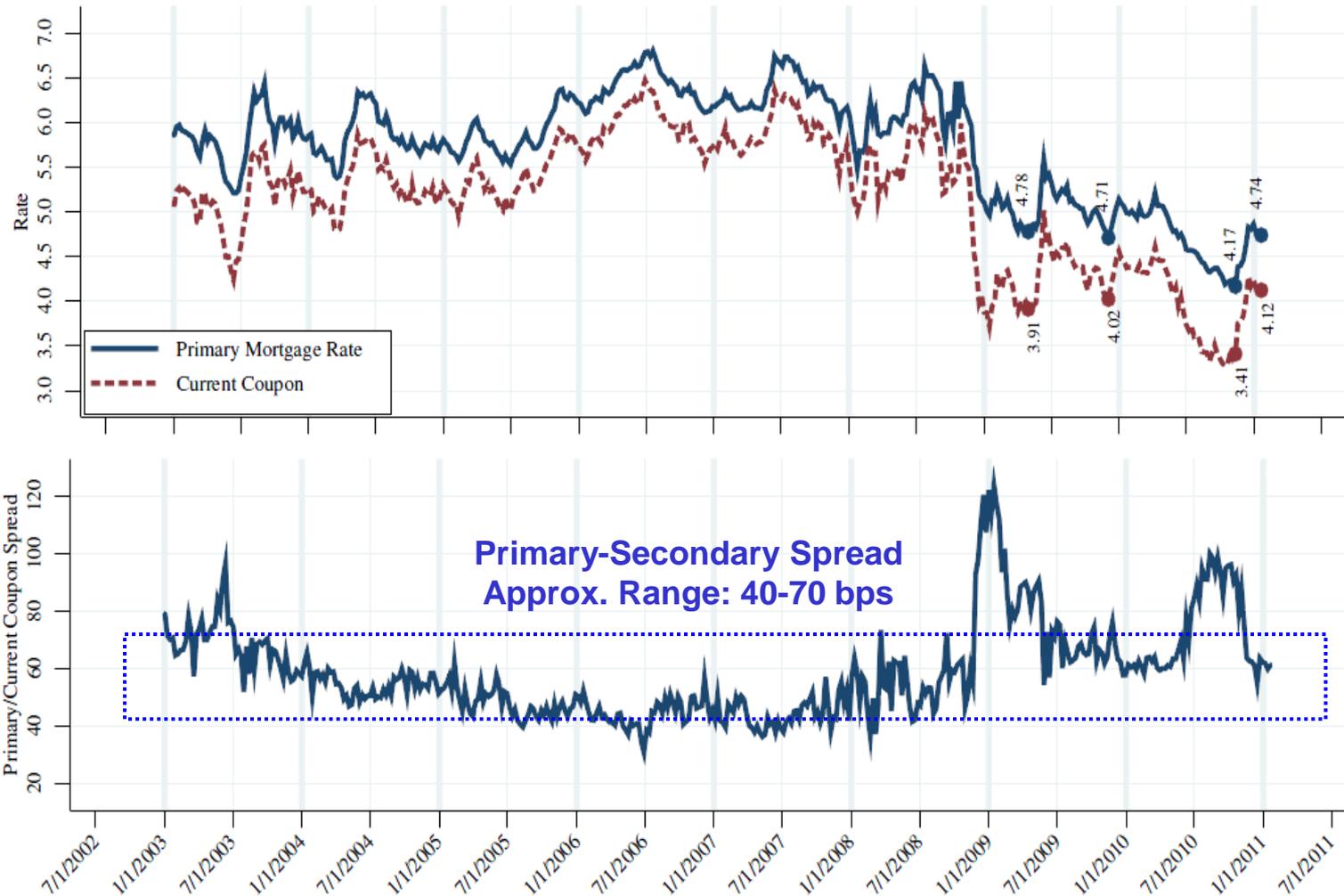
## Proposals: Fee for Service

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- ❑ The guarantor would pay a set dollar fee per loan (e.g., \$10/loan) or basis point fee (e.g., 5 bps - 8 bps), for performing loan servicing and would be reassessed at least annually for material changes to servicing requirements, inflation or costs
- ❑ Non-performing loan compensation would be incentive/outcome-based for standard NPL activities/outcomes (e.g., Servicing Alignment Initiative)
- ❑ Selling and servicing representations and warranties would be bifurcated
- ❑ Two potential options for managing excess IO cash flows above the MSF:
  - ❑ Option A - Excess IO Contractually Tied to the MSR (Status Quo)
    - ❑ The seller could choose to retain excess IO or sell it to the Enterprise through a buy-up at the time of securitization
    - ❑ Retained excess IO would be part of the MSR and would likely be capitalized because it would be in excess of adequate compensation
    - ❑ Any transfer of excess IO would still require agency approval prior to transfer and upon termination would transfer to the subsequent servicer.
  - ❑ Option B - Excess IO Contractually Separated from the MSR
    - ❑ The seller could choose to either sell excess IO to the Enterprise through a buy-up at the time of securitization or receive an excess IO interest which would be separated from the MSR's servicing compensation
    - ❑ Any excess IO interest held would be an asset on the seller's balance sheet, but would not be a part the MSR; thus, it would not be a part of the adequate compensation assessment (and thus servicing compensation would likely not be capitalized)
    - ❑ The excess IO interest would not automatically transfer upon termination and agency approval would not be required for sale or transfer

# Appendix: Historical Primary-Secondary Spreads

## Mortgage Rates – Primary & Secondary



Source: Amherst Mortgage Insight, January 24, 2011

# Appendix: Illustrative Lender Values with MSR, G-fee and CTS Differences

This simplified illustration is intended to facilitate discussion on the relative differences in lender valuations arising from three often-mentioned factors heard throughout the stakeholder feedback process:

- (i) g-fee differentials
- (ii) economies of scale (costs to service) differentials, &
- (iii) capitalized MSR (MSF, Excess IO, Float & Ancillary, & CTS) valuation differentials under the current 25 bps MSF model.

Illustrative Summary Loan Value Differences:	
Lender A Loan Value	101.91
less Gfees & BU/BD differential impact	(0.14)
less Float & Ancillary differential impact	-
less Cost to Service differential impact	(0.08)
<b>MSR</b>	(0.70)
less Base MSF multiple differential impact	(0.53)
less Excess IO multiple differential impact	(0.09)
less Net Cost to Originate differential impact	-
Lender B Loan Value	101.08

Loan Assumptions	
Loan Amount (\$)	\$175,000
Expected Duration/WAL (yrs)	5.00
Base MSF (bps)	25.00
MBS Coupon Price (bps)	101.00
Excess Spread contractually part of MSR	TRUE

Lender Assumptions		
	Lender A (price setter)	Lender B (price taker)
Mortgage banking spread (bps) (priced by lender at origination)	40.0	
Excess Spread (bps)	15.0	
Loan Note Rate [=MBS 4% + Gfee + (MSF+XS-IO)]	4.625%	4.625%
Gfee (annual bps)	22.5	26.5
Buy Down multiple	3.4 x	3.4 x
Float & Ancillary NPV (bps)	0.33	0.33
CTS (\$/loan/month)	\$5	\$8
CTS NPV (bps)	13.7	21.9
Base MSF multiple	4.0 x	1.9 x
Excess IO multiple	4.0 x	3.4 x