

# December 26, 2011

Mr. Edward DeMarco

Acting Director

Federal Housing Finance Agency

1700 G Street, NW, 4th Floor

Washington, DC 20552

Submission to: Servicing\_Comp\_Public\_Comments@FHFA.gov

Re: *Alternative Mortgage Servicing Compensation Discussion Paper*

Dear Mr. DeMarco:

Aerospace Federal Credit Union appreciates the opportunity to comment on the Federal Housing Finance Agency’s (FHFA) “Alternative Mortgage Servicing Compensation Discussion Paper,” released September 27, 2011. The following responds to the issues raised in this paper and prior discussions FHFA, Fannie Mae, and Freddie Mac have had on this subject.

In order to provide a fair response to the FHFA proposals, the basic issues regarding servicing, including but not limited to, today’s servicing problems, how servicers are compensated, impact of proposed changes on **all** lenders (not just the big lenders), and how the proposed changes will improve servicing current future delinquent or non-performing loans, must be examined.

The FHFA’s September 27, 2011 “Discussion Paper” fairly describes how servicing works (see pages 3 and 4). Most importantly, the FHFA identifies “(c)ustomer service is a key aspect of managing this relationship…(and) the servicer’s responsibilities encompasses the entire life cycle of the loan, whether through a payoff, an REO disposition, a third party foreclosure sale…” What this means is interaction by the servicer with the borrower from the time the loan is set up for servicing until the loan is paid off, regardless if that payoff is through the normal repayment process or foreclosure, short sale, or deed in lieu.

As servicers know, most borrowers do not want or require a lot of attention. Once the loan payment process is set up, most borrowers make their loan payment monthly. The only interaction between a servicer and borrower generally occurs when a borrower has a question about their loan (e.g., was a payment posted, where do I pay my real estate, etc.) or when a borrower is delinquent—which until 2008 was minimal for most borrowers (i.e., except for sub-prime borrowers who have historically been two to four times more delinquent than prime borrowers; however, until the mid-part of this past decade (i.e., 2004 – 2007) most servicers did not service sub-prime loans). The result of this unique relationship (i.e., little attention required in a high touch customer environment) allowed servicers to focus on making their servicing operations more efficient. To that end, servicers made technology investments that improved productivity (in particular, automated response phone systems minimized time consuming personal interaction) and resulting in staff reductions as more loans could be serviced per employee.

Unfortunately, these improvements were not able to help servicers when the infamous 2007 recession began. The problems this recession produced were unlike any since the 1930s. Prime loans began to falter as unemployment skyrocketed and housing prices plummeted. While sub-prime loans had always required intensive servicing, prime loans began requiring the same type of attention. Unable to afford their monthly payments and/or sell their homes (i.e., in order to cure their delinquency), an increasing number of prime borrowers experienced severe delinquency and some, foreclosure (although many delinquent borrowers were cast into a prolonged and uncertain delinquency). No longer were the systems previously installed able to handle the flood of calls and requests for assistance (i.e., prior systems were built based on simple answers, quick responses, and little or no need for personal interaction) nor were staffs capable of responding as servicers were unprepared with solutions—servicers had never experienced anything like what was happening (high unemployment, cratering home prices, and home values sinking far below loan amounts) and no one knew when (or if ever) things would improve.

As the FHFA points out on Page 4, the functions required to service (the high quantity of) delinquent loans are numerous, labor intensive, time consuming, and difficult (as servicers try to find solutions that meet the needs of the borrower, servicer, and investor). The time and will (or incentive) to install the infrastructure required and acquire the technology needed to handle today’s problems and the cost for more staff that can work with troubled borrowers along with the uncertainty as to when housing values will turn around and unemployment improve continue to produce inertia, a lack of viable solutions, and on-going delinquency and foreclosure.

**The Reserve Account or Fee for Service**

FHFA’s proposed changes, Reserve Account or Fee for Service, do not solve today’s servicing problems or servicing problems in the future if high delinquency rates return. The proposed changes seem to be for the benefit of large lenders in managing their MSRs and have nothing to do with solving the problems related to the historically high number of borrowers who are delinquent and seeking solutions or the inability of servicers to provide minimally adequate service or responsible solutions. Both the Reserve Account and Fee for Service proposals typify what appears to be FHFA’s absolute lack of concern for any but the large lenders.

The FHFA proposal missed the “real” servicing problem, and what should have been the intent of the proposed changes, solving how to compensate and incent servicers struggling with delinquent loans, a diminished income stream (i.e., as loans go delinquent), inadequate technology, and servicing contracts that encourage simple solutions, quick fixes, and little personal contact (i.e., since servicers receive no income from delinquent loans, they support their staff and operational costs from loans that are paying—the “incented” income provided by Fannie Mae and Freddie Mac to servicers who provide borrowers modifications or loan workouts is inadequate at best and derisory at worst.

Additionally, the proposed Reserve Account and Fee for Service seems to ignore or completely disregard the harmful and damaging impact of these changes to small and medium size lenders. While Fannie Mae and Freddie Mac acknowledge the importance of small and medium size lenders (they significantly outnumber the big lenders but not in loan volume) and the problems they have, the big lenders provide Fannie Mae and Freddie Mac with the most loans—which the FHFA proposal seems to imply entitles them to assistance (i.e., the proposed changes provide MSR relief and little more).

Had FHFA looked at the problems small and medium size lenders have with the proposed changes they would have found:

* Many small and medium size lenders use the Fannie Mae and/or Freddie Mac cash window when they sell loans to these entities; most never securitize. The proposed changes intimate that all lenders do this and the proposed changes would be easily accomplished as a result of similar behavior.
* The small and medium size lenders who sell at the cash window set up their MSRs when loans are sold and amortize them accordingly after the sale. Most do not have problems managing them or making adjustments to them if required. Most do not hedge their MSRs, they do not the staff or expertise necessary to manage this financial tool.
* MSRs provide small and medium size lenders the ability to compete in the mortgage loan market with the big lenders. The MSRs allow small and medium size lenders to take reduced premiums from the sale of loans to Fannie Mae or Freddie Mac and still have sufficient income to support a mortgage operation (i.e., with the current MSR structure).
* Because of their huge loan volumes big lenders can negotiate with Fannie Mae and Freddie Mac:
* Relief from Fannie Mae and Freddie Mac’s fee adjustments (e.g., Ally Bank does pay the 1% California condominium fee from Freddie Mac—small and medium size lenders have to pay the fee), and
* Guaranty fees (g-fees)—some only pay single basis points g-fees versus the 20 plus basis points g-fees paid by small and medium size lenders.

These cost differences allow big lenders to drive market share and competitors from the market as such competitors have difficulty matching the big lenders lower rates (the g-fees make a differenc) and loan costs (i.e., from fee relief) without incurring losses.

The small and medium size lenders must pay (or collect from borrowers) the fees charged by Fannie Mae and Freddie Mac and they pay significantly higher g-fees (i.e., sometimes two to three more than the big lenders). To compensate for this disadvantage, small and medium size lenders will reduce the premiums they receive from the sale of loans to Fannie Mac and Freddie Mac and rely, instead, on MSRs to support their operation. Without the income MSRs generate (at current levels), many small and medium size lender will have to increase interest rates to achieve a higher premium to support their mortgage operation or charge higher origination fees. Either way, competing with the big lenders becomes even harder. The result: some small and medium size lenders (are forced to) exit the market, large lenders increase market share, and (what may be one of many underlying reasons for the proposed FHFA changes) Fannie Mae and Freddie Mac reduce the support costs they incur serving a vast number of small and medium size lenders—their support can be concentrated on a reduced pool of lenders.

For many small and medium size credit unions this is an especially critical problem; many credit unions only make a few basis points at the sale of the loan to Fannie Mae or Freddie Mac. They do not charge origination fees; they rely on MSRs to provide sufficient income to support their mortgage operation. Without the current MSR structure, credit unions will have to increase rates to obtain premiums sufficient to support their operations or they will have to charge origination fees—an anathema to both credit unions and credit union members (the latter of which will most likely see their credit union as just another mortgage lender, negating the special relationship they have with their credit union).

* The Fee for Service represents a unique idea but one which really only benefits the large lenders. It appears that the proposed fee (see next) will be based on the most efficient servicing operations, which can only be achieved by the large lenders (i.e., those who service millions of loans, not thousands of loans.

While it is duly noted that the proposal says the “compensation level is currently expected to be $10/performing loan and will be confirmed once there is clarity on servicing requirements,” one remains very skeptical as to any change in this number, regardless of “clarity on servicing requirements” since it seems to be the practice that once a number is proposed by a Federal agency, that number typically remains unchanged, regardless of additional clarity.

Whether the fee is $10 per month or twice that (or some basis point byproduct), for most small and medium size lenders, it is not enough to cover their cost of servicing. Many small and medium size lenders, to reduce the costs of in-house servicing systems and staff, rely on subservices, such as Cenlar FSB or Dovenmuehle Mortgage, to service the loans they sell. These operations charge small and medium size lenders from $10 to $20 per loan serviced per month. This cost does not include the staff time and reporting requirements that the small and medium size lender incur once they receive monthly information from their sub-servicers or the phone calls the lenders have to handle despite a borrower’s loan being sub-serviced.

Notably, Midwest Loan Services, a credit union sub-servicer, costs $6.00 to $7.00 per month per loan for sub-servicing. While this is a very competitive low cost, credit unions are Midwest’s focus; its cost structure is based on performing loans—most credit unions avoided sub-prime and Alt A loans when the loans were a “hot” commodity. However, even with this low cost, the $10 per month would not be sufficient to pay the costs credit unions incur to monitor, analyze, and track the loans sub-serviced by Midwest or handle the number member loan calls (i.e., credit union members are a high touch group, they want communication with their credit union—not just their sub-servicer).

Additionally, ancillary income is only earned if received—and, if loans are performing late fees are not earned and if loans are sub-serviced, escrow income is generally retained by the sub-servicer. Thus, little or relief will be obtained from this income stream by small and medium size lenders.

And, while the proposal says that “the guarantor may pay the servicer incentive compensation” any representation that the guarantor will make incentive payments is specious at best. “May” is the operative word—with the conservatorship of Fannie Mae and Freddie Mac no incentive compensation should be expected since it would produce a cost for Fannie Mae and Freddie Mac and thereby require more taxpayer support (which is not something the conservator is likely to allow). What is considered probable, however, is the “assess(ment of) compensatory fees”; this would provide Fannie Mae and Freddie Mac with income (which is something the conservator seeks).

Finally, the proposal seems to fix the fee that will be paid for a loan’s entire loan term (i.e., $10 per month for 10, 15, 20, or 30 years—depending on loan term); the proposal fails to consider how a servicer will act or be able to perform when receiving a fixed fee as costs go up (note: the present value of $10 in 10 years with an inflation rate of 4% is approximately $6.75) and more importantly, does not make any accommodation for change as costs go up. Perhaps an oversight—if so, it raises questions as to what type of process was performed in determining how and how much to compensate servicers for servicing loans. If not an oversight, it is troubling!

The counter point to this fixed, low cost fee proposal is that the “guarantor will collect a master servicing strip from the interest payments made by the borrower to fund the dollar fee per loan payments to servicers.” The proposal envisions this strip to be equal to eight basis points of the loan amount.

* “Guarantor” (i.e., Fannie Mae or Freddie Mac) income is based on loan amount; the bigger the loan, the more the guarantor makes. Thus, if a loan amount exceeds $150,000, based on the proposal that the guarantor receive 8 basis points to fund the servicing fee of $10 per month, the guarantor actually profits. If a loan amount is $400,000: at 8 basis points the guarantor receive $320 annually while paying out $120 to the servicer (i.e., the $10 monthly fee), leaving a profit of $200. Nothing in the proposal says that the guarantor will use any overage it receives to fund higher servicer payments or to assist servicers in adding infrastructure and/or staff to service non-performing loans.
* The “guarantor” in proposal is Fannie Mae or Freddie Mac; both are in conservatorship. There is no guarantee that they will not go bankrupt. Thus, any fees collected by them (e.g., the eight basis point strip) may not be available to pay a monthly servicing fee since a bankruptcy trustee could deem funds collected by the bankrupt estate (i.e., Fannie Mae or Freddie Mac) belong to the estate, not to the servicers (even if documents set forth **how** funds will be distributed when collected by the guarantor). Currently, servicers are paid out of a loan; Fannie Mae and Freddie Mac do not pay monthly payments to servicers—the proposal is a dramatic shift in control over cash flow.
* As the current crisis has shown, the cost to service non-performing loans is extremely high. Since the proposal does not require any overage set aside (i.e., if the “guarantor” receives more income from the “master servicing strip” than it pays out for the monthly servicing fee), the “guarantor” cannot provide servicers with the compensation needed to handle non-performing loans.

Neither the Reserve Account or Fee for Service proposals meet one of the reasons FHFA stated as a need for changing how loans are sold to Fannie Mae and Freddie Mac: “The IO strip…results in a servicer receiving more than enough income to cover the expenses of servicing performing loans, but not enough when a portfolio includes a significant number of non-performing loans.” The proposals do not address how servicers will be helped with their non-performing loans now or in the future.

Finally, while the proposal stresses that the changes will increase competition it is very difficult to determine how this is accomplished, except amongst the large lenders. Certainly the small and medium size lenders will struggle with this proposal. The fee is unrealistic, the need to manage an I/O strip is impractical (i.e., from a lack of a knowledgeable staff and to costs to add staff), and the inability to *quickly* identify what premium to take based on a fixed MSR creates an improbable competitive environment for small and medium size lenders.

**Providing a Solution**

FHFA’s proposed changes, whether the Reserve Account or Fee for Service, do not solve the address the problems of servicing loans today or in the future if high delinquency rates return: the technology and staff required to provide timely servicing of and viable solutions for severely delinquent loans. In fact, the changes proposed ignore these problems in favor of finding a solution to managing mortgage servicing rights (MSRs).

The solutions required for today’s servicing problems (and high delinquency if it returns) should focus on how to get servicers to make the investments required in technology and staff that will allow the effective and timely servicing of loans in a high delinquency environment. The following outlines how this could be accomplished using some of the tools listed in the proposed changes:

* Pay servicers even if the loan is delinquent; servicers have on-going, real costs when borrowers stop paying—they are penalized (i.e., they still have to service a loan if it is delinquent) for not collecting from borrowers who cannot pay. Servicers focus on loans that are paying monthly and timely; that is how they meet payroll, pay expenses, and remain in business.

The amount paid for delinquent loans could be equal to the last payment the servicer received or could be a flat dollar amount. There could be a time limit for payment (e.g., 12 months) along with a requirement of repayment from the servicer if the servicer does not resolve the delinquency (i.e., the borrower returns to current payments, the loan is modified, or foreclosure is started/completed).

* Pay a bonus or incentive for each loan brought out of delinquency, whether through modification, foreclosure, or current payments; there would need to be guidelines, such as how many payments must be made timely, type of modification (i.e., cutting a loan amount 50% may not be as desirable as foreclosure), and minimizing the loss to Fannie Mae and Freddie Mac (this could be a standardized worksheet).

The bonus or incentive payment must be reasonable and attractive: $2,000 is too little; $5,000 to $10,000 will get the servicers’ attention. Notably, this bonus or incentive could be a bifurcated payment: half as a current reward, half required to be put in a reserve that is spent on technology or additional staff (must be documented by the servicer). It can be argued this cost will increase the loss to Fannie Mae and Freddie Mac; however, delinquent loans are costing a lot of money today along with continuing losses to Fannie Mae and Freddie Mac.

* Provide servicers with low cost loans to build the infrastructure and add the technology needed to handle today’s high touch servicing requirements and “forgive” a portion of the low cost loan upon timely completion (it’s a bonus for timely installation).

There would need to be a set of requirements established for such systems and a deadline set for installation. Again, while this cost will increase the loss to Fannie Mae and Freddie Mac, it is costing a lot of money today as delinquent loans remain suspended, pending the servicers’ response.

Fannie Mae and Freddie Mac have implemented some incentive programs meant to get servicers attention to delinquent loans but these programs are an anemic response to a potent, unrelenting problem. The goal of these recommendations is to get servicers to focus on solving delinquent loan problems, not ignoring them. Fannie Mae and Freddie Mac will incur additional costs for these solutions but the taxpayers are already paying a high price for delinquency that lingers, foreclosures that drift, and servicers that vacillate—it just has not been monetized.

Finally, the only way to make the payments under this proposal is to have them come from Fannie Mae or Freddie Mac. As we continue working through this crisis, there needs to be solution that makes Fannie Mae or Freddie Mac responsible for the payments without incurring a loss. While it will take time, it can be achieved with one of the changes proposed by the FHFA (see next, Making a Reserve Account Work).

**Making a Reserve Account Work**

While the Reserve Account proposal is meant to change the way mortgage servicing rights are handled, there is one aspect of it that could be used by Fannie Mae and Freddie Mac.

Currently, most mortgage lenders sell loans to Fannie Mae and Freddie Mac with servicing retained. Fannie Mae and Freddie Mac pay the selling lenders a fee to service the loans. Generally, this fee is equal to 25 basis points (0.25%) of the loan amount and is paid monthly from the borrower’s loan payment (i.e., ⅟12 of the 0.25%); the fee is slightly higher for FHA loans.

Based on accounting rules (i.e., in accordance with Generally Accepted Accounting Principles or GAAP), lender/servicers who are paid this fee (i.e., monthly as they service a loan) must recognize its estimated full value on a capitalized basis currently; this capitalized asset (i.e., MSRs) is then amortized over the estimated life of the loan. How much this capitalized fee is really worth remains a highly charged conversation.

However, the monthly fee the lender/servicer receives for servicing a loan is paid in cash and recognized by the lender/servicer when received. As noted in the FHFA paper, and confirmed by almost all lender/servicers, the 25 basis points is more than adequate to cover the costs of servicing a performing loan (which all loans are when they are sold to Fannie Mae or Freddie Mac). As a result, there is room to reduce this fee and still make loan servicing a profitable and desirable part of a mortgage lender’s operation.

Based on the FHFA paper and feedback received by the FHFA, a 3 to 5 basis point reduction to the 0.25% servicing fee would not harm the servicing of performing loans. Thus, Fannie Mae and Freddie Mac could require that lenders who sell loans to them pay monthly a fee equal to but not more than 20% of the income they receive from the servicing fee that Fannie Mae and Freddie Mac pay for servicing loans—or 5 basis points of the 25 basis points fee. The fee could be remitted monthly to Fannie Mae or Freddie Mac, as applicable.

FHFA could require that the fee paid to Fannie Mae and Freddie Mac be set up a non-comingled reserve fund and that it could only used to make the bonus / incentive payments and/or infrastructure / technology loans—the funds should not be allowed to be used for any other purpose.

Based on the requirement that a lender pay 5 basis points of the 25 basis points received as a fee to service a loan the 5 basis point fee should be a deduction from the lender’s MSR calculation. If this is not achievable under GAAP based on this methodology set forth, it is suggested that Fannie Mae and Freddie Mac reduce the fee they pay for servicing loans to 20 basis points and be required to set aside 5 basis points monthly from the interest paid to them for a loan that is serviced. The goal is to have a reserve fund set up that builds loan by loan and allows Fannie Mae and Freddie Mac to assist and incent lenders as needed.

NOTE: Fannie Mae and Freddie Mac charge lenders a 25 basis point market adverse fee for every loan they purchase; it is possible that Fannie Mae and Freddie Mac could take the 5 basis points for the Reserve Account from this fee or they could increase this fee to 30 basis points and set aside 5 basis point for a Reserve Account. If the market adverse fee is used in place of the servicing fee, no change should occur with the current servicing fee arrangement between lenders and Fannie Mae or Freddie Mac.

**Development of a Different Servicing Fee Structure**

The FHFA is a government agency charged with managing and regulating “Fannie Mae, Freddie Mac and the Federal Home Loan Banks…support housing finance and affordable housing and support a stable and liquid mortgage market.” FHFA is not charged with establishing the workings of the secondary mortgage market (which it is doing since Fannie Mae and Freddie Mac are the only real participants in that market). The secondary mortgage market is supposed to be a market driven operation, not a government mandated operation—which is what will result if the FHFA’s proposed changes are adopted.

Additionally, settling on the role, if any, Fannie Mae and Freddie Mac will have in the future should be done before any changes are made to how they operate (i.e., changing the servicing fee). FHFA should continue to manage and regulate Fannie Mae and Freddie Mac in a manner that allows them to support the needs of mortgage financing.

The proposed changes regarding how lenders will be paid for loan sold to Fannie Mae or Freddie Mac seems to be beyond the scope of the conservatorship; regardless, changes such as these should be made by the market. The market is capable of making the changes it wants; a government agency should not be playing the lead and the only role as a change maker.

Finally, it seems that the proposed changes are for the sole benefit of large lenders as they try to manage MSRs in an uncertain economic environment. The needs of small and medium size lenders appear to have been ignored, or at least overlooked, in the proposed changes. FHFA should go back and relook at what changes are really needed to assist servicers in overcoming the challenges they face with the current high delinquency rates and unresolved delinquent loans—changing how to pay for the purchase of loans can wait until today’s crisis is resolved.

Aerospace Federal Credit Union appreciates the opportunity to comment on the FHFA’s proposed changes. Any questions should be directed to Ed Casanova, Vice President, at 310-336-0776 or ecasanova@aerofcu.org.

Again, thank you.

Ed Casanova

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Aerospace Federal Credit Union