From: thoward@phoenixmortgageassociates.com [mailto:thoward@phoenixmortgageassociates.com]
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To: #Servicing Compensation
Subject: Comments of the Alternative Mortgage Servicing Compensation Discussion Paper

To Whom It May Concern:

I am a semi-retired Citibank executive, having served for many years as Senior Credit Officer and the Director of Consumer Credit Policy. I also served for ten years as CEO of a multi-state mortgage banking company which was an approved seller/servicer to both Enterprises and contract servicer to Freddie Mac's "Failed Institutions" department. I am also a founding member of the American Association of Residential Mortgage Regulators (AARMR), and an Expert Witness qualified in Federal Court on mortgage banking matters. Before I address some of the specific questions raised in the Discussion Paper of the FHFA's joint Mortgage Servicing Compensation Initiative, I would like to point out some serious misconceptions in the underlying assumptions which I believe warrant clarification. The issues relate specifically to the current compensation model.

"Current Compensation Model" Lacks Critical Information

In the current compensation model, reference is frequently made to the Enterpriserelated MSR as "collateral" for the seller/servicer's representations and warranties, and as representing "skin in the game," or an "investment." Such references create the false impression that "owners" of Enterpriserelated MSRs actually "own" something of value that can serve as "collateral," "skin in the game," or "investments." The appearance of value is also supported by the fact that the accounting profession has elevated an Enterpriserelated MSR to a Level 3 Asset status, and federal banking regulators treat an Enterpriserelated MSR as Tier 1 capital. Nevertheless, the premise is false and reflects a lack of understanding of what an Enterpriserelated MSR truly is. What the authors of the Discussion Paper and apparently the accounting profession and federal regulators as well either do not know or fail to recognize is the fact that when a lender sells a mortgage note to an Enterprise, it sells that note **"in its entirety,"** regardless of the price paid by the Enterprise for the mortgage note or any non-monetized interest allegedly retained by the seller. **"In its entirety" means that " <u>the seller retains no equitable interest whatsoever in either the note or the net yield spread (the MSF, and any excess IO)</u> ."** Consequently, the **<u>entire</u>** retained servicing fee, the MSF and any excess IO (that which the Position Paper purports to give an Enterprise related MSR its monetary value) becomes the property of the Enterprise upon the purchase of the note. Stated simply, everything that is not monetized in the seller's "best execution" decision becomes the property of the Enterprise upon the sale of the note. The seller retains nothing. The fact that the lender/seller determines the amount of the retained servicing fee (MSF and any excess IO) and decides how much to monetize is irrelevant. **Upon the sale of the note, the MSF and any excess IO becomes the property of the Enterprise along with its purchased principal and "net yield interest."** This may surprise some readers since you probably won't find these facts anywhere in the Enterprises "seller/servicer" manuals, but they are indisputable documented facts nonetheless.

An Enterprise Related MSR Is A Performance Contract Only

Because the Enterprise owns the note "in its entirety," an Enterprise related MSR is nothing more than a performance contract with rights to an income stream (servicing compensation) which can be easily terminated. The income stream (servicing compensation) is paid to the contracted servicer by theEnterprise from theEnterprise's own funds, the acquired IO strip which includes the MSF and excess IO, if any. Thus, an Enterprise related MSR is similar to a contract you might have with your landscaper. You grant him a contractual right to mow your lawn for which he will be paid. If you are satisfied with his performance you pay him. If you are not satisfied with his performance you terminate his contract and no longer pay him. The landscaper's contract right to mow your lawn and be paid by you for his services can hardly be considered "collateral" for the performance of his duties, nor does he have any "skin in the game," or "investment" at risk. Equally obvious, and more importantly, his contract with you has absolutely no asset value.

Freddie Mac states these facts very succinctly: "Freddie Mac **allows** its servicers to deduct their servicing fee directly from the funds collected on Freddie Mac's behalf from the borrower, rather than having the servicers **remit the full amount** collected to Freddie Mac, with Freddie Mac later paying the servicer directly." (Emphasis added.) Obviously, Freddie Mac's claim of entitlement to the "full amount" confirms its ownership of the MSF and any excess IO. Furthermore, according to Freddie Mac: "the right to the "net yield spread" (the MSF and any excess IO) is at most a contract right – the means by which a servicer's compensation for servicing the loans it had sold to Freddie Mac is calculated. Moreover, the servicer is obviously entitled to such compensation only as long as it is actually under contract and earning it. Consequently, as with the Servicing Rights, any interest the servicer had in the net yield spread (MSF and any excess IO) is extinguished upon its termination by Freddie Mac, after which it no longer services Freddie Mac's mortgages." Clear enough? So, exactly where is the seller/servicer's "collateral" asset value, "skin in the game," or "investment" that is alleged in the Discussion Paper? One might also ask on what basis the accounting profession and federal banking regulators justify raising a simple performance contract with no inherent monetary value to the level of a financial asset. Landscapers should be so lucky.

The "Fee For Service" Alternative Is Not An Alternative

Given these irrefutable facts, there is obviously no need to consider a "fee for service" alternative. The current compensation model is a ***de facto*** "fee for service" arrangement. According to the Discussion Paper, in the proposed "fee for service" model, 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." Clearly, this already exists as described above. The only difference is that the servicer withholds the servicing fee from the borrower's payment instead of remitting the full amount of the payment to the Enterprise and then having the Enterprise later paying the fee to the servicer. The only real issue for discussion is the amount of the fee which is currently determined by the seller/servicer.

"Option B" Is Not An Option

Additionally, Option B under the "fee for service" model, which states that a seller would retain an excess IO strip contractually separated from the MSR, is equally impossible and is therefore not a valid consideration for discussion. As stated earlier, an Enterprise purchases note "in its entirety," and therefore owns the entire IO strip regardless of the amount of the excess IO strip (and MSF) established by the lender at the time of securitization or the price paid by the Enterprise for the mortgage note. Contractually separating the excess IO strip from the MSR would require the Enterprise to grant the seller/servicer an equitable interest in the mortgage note to the extent of the excess IO strip, something he currently does not have. This would represent such a massive departure from current practice that it would turn the mortgage banking industry on its ear and materially alter the entire loan pricing structure. Currently an Enterprise acquires the MSF and any excess IO without paying for it since the loan pricing is based upon a "net yield" pass-through rate of interest plus any excess IO the lender is willing to monetize. That effectively gives the remaining MSF and any excess IO acquired by the Enterprise a **value of zero** since it is included in the transaction without additional benefit to the seller. Exactly how and why then would excess IO separated from the MSF suddenly have monetary value?

I believe that these apparently little known facts alter the discussion materially and should certainly be included in the Discussion Paper before any changes to the current model are seriously contemplated.

Selling and Servicing Representations and Warranties Should Be Bifurcated

Lastly, I fully agree that selling and servicing representations and warranties should be bifurcated. It is utterly ridiculous that a servicer who is not the originator should be responsible for the quality of the loan underwriting or its conformity to the guidelines. That is just self-serving cover-up for Enterprise quality control incompetence. If you are buying a loan, have the quality control procedures in place to assure yourself that you are getting what you pay for. Don't make it the landscaper's problem!

Ted Howard

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