RESIDENTIAL SERVICER COALITION

December 22, 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 Acting Director DeMarco:

This letter provides comments on the September 27, 2011 Alternative Mortgage Servicing Compensation Discussion Paper (Discussion Paper) on behalf of the Residential Servicer Coalition (RSC). Members of RSC are mortgage servicing companies, many of whom have a business specialty in the management of under-performing and non-performing mortgages, with an objective to return those loans to performing status whenever possible. A number of RSC member companies work with community banks and other community-based lenders to subservice the mortgage loans these lenders originate.

Our comment letter is divided into three parts. Initially we set out what we believe should be the goals of the compensation structure for mortgage servicing. Next, we discuss the specific proposals contained in the Discussion Paper. Finally, we present our recommendations on refinements and enhancements that we believe will permit full realization of the goals set out at the start of the Discussion Paper:

- improved service to borrowers,
- reduced financial risk to servicers,
- better control over delinquent loans for guarantors, and
- continued liquidity in the TBA market.

Objectives for Mortgage Servicing Compensation Structure

There are five objectives that RSC believes are important to achieve in any change to the mortgage servicing compensation structure.

1. Ensure that mortgage servicers continue to have "skin in the game" by having a stake in the successful performance of the servicing portfolio;

2. Establish *outcomes based* standards for the management of non-performing loans (NPLs), with incentive payments financed through a reserve account;
3. Set *a range* for the minimum servicing fee that will allow servicers to maintain the value of their mortgage servicing rights (MSRs) at the level that reflects the varying cost structures and business models in the servicing industry, consistent with the interests of borrowers, investors and guarantors;
4. Facilitate the bifurcation of selling and servicing representations and warranties; and
5. Enhance diversity and competition in the market.

Skin in the Game – The current compensation structure for mortgage servicing results in the creation of an MSR asset, owned by the mortgage servicer. That asset creates an income stream to the servicer that is maximized by the servicer by:

- keeping the loans performing,
- returning delinquent loans to performing status as quickly as possible through forbearance or loss mitigation, and
- acquiring and liquidating the collateral expeditiously through short sales, deeds-in-lieu of foreclosure, and foreclosure.

This compensation structure causes mortgage servicers to have a strong financial stake in the successful performance of the servicing portfolio. While the basic compensation framework is strong, as pointed out in the Discussion Paper, there are some shortcomings to the current system, particularly when markets are stressed. One of the key limitations of the current structure is the fact that a mortgage servicer's primary income stream is dependent upon keeping a high percentage of the portfolio performing, since they only collect servicing fees on performing loans.

When external economic events cause delinquencies to spike, costs for primary mortgage servicers (as opposed to subservicers and special servicers) escalate dramatically, while their servicing income falls off sharply. This is because the costs of managing delinquent loans are significantly higher than for performing loans, and no servicing fee is collected on a delinquent loan. The management of delinquent loans is very labor-intensive and time consuming. Both of these factors push costs for the management of delinquent loans to 4-5 times the costs of servicing performing loans.

It is important to preserve the "skin-in-the-game aspects of the current structure. Enhancements to the compensation model should focus on providing primary servicers with the financial resources to better manage unanticipated spikes in delinquencies either internally, or through contractual arrangements with subservicers and distressed servicing specialists, as noted below.

Incentives Aligned with Performance – The management of large numbers of under-performing and non-performing loans requires a specialized administrative expertise together with significant investments in skilled talent and technology. Yet, as noted above, under the current compensation structure, the income flow from a mortgage servicing portfolio is declining during times when delinquencies are rising. Mortgage servicers are incented to return loans to performing status in order to restore their income flow, but an outcome that features a return to performing status is not always possible. There are a variety of other resolutions that may well be preferable to foreclosure, including a short payoff, a short sale of the home or a deed in lieu, none of which under the current compensation structure generates income for the primary mortgage servicer, but may be in both the homeowner's and investor's best interest.

Any change to the mortgage servicing compensation structure should align the mortgage servicer's incentives with performance outcomes that are in the best interests of consumers, guarantors and investors. We believe requiring the establishment and funding of a reserve account to finance outcomes-based management of NPLs -- either in-house or through outsource arrangements with servicers specializing in managing defaulted loans or distressed portfolios -- is the most important refinement to the servicing compensation model. This reserve account should be set at a percentage of the unpaid principal balance of the servicer's GSE portfolio, and at a level high enough to ensure that the higher costs of specialized default management can be properly compensated.

Outcomes-based – This suggested goal is closely aligned with the Incentives goal above. A mortgage servicing operation approved to service GSE loans is the product of a considerable investment of money, time and talent. The knowledge and skill inherent in the organization, and the individual employees, are very focused on producing superior results for the investors whose assets they service and for the mortgage servicing company, both financially and operationally. The highest and best returns for both investors/guarantors and servicers will be achieved when the mortgage servicers are allowed to focus on performance-based outcomes, rather than process-based activities.

We believe that both the GSEs and primary servicers have found that outsourcing distressed portfolios to specialized companies has improved outcomes. And yet each of the companies represented in the RSC has different business models and processes for their default servicing. We believe this diversity is important and healthy. Toward that end, changes in the mortgage servicing compensation structure for NPLs should be aimed at driving positive performance outcomes, rather than dictating that detailed, specific processes be followed. It will produce better results for borrowers and investors alike if mortgage servicers are allowed to utilize the full range of their talent, expertise, technology and innovation to do their job.

Bifurcation of Representations and Warranties – One of the major obstacles to the efficient transfer of mortgage servicing rights, and to the entry of new competitors into the mortgage servicing business, is the current linkage of selling and servicing representations and warranties. Unless negotiated with the GSEs, a mortgage servicer that acquires the MSR also acquires responsibility for the selling representations and warranties associated with the originator(s) of the loans. In order to limit their exposure, mortgage servicers have to obtain, and be prepared to enforce, their own representations and warranties from the loan sellers. These are complex negotiations that are often difficult and/or costly to consummate. The inability to satisfactorily resolve these representation and warranty issues – particularly in light of the distressed market conditions – has significantly limited the volume of servicing transfers that could be consummated.

Importantly, the Discussion Paper proposes a bifurcation of these two sets of representations and warranties, but limits this option to the fee for service model. We believe that any change to the mortgage servicing compensation structure should include a mandatory bifurcation of the two sets of warranties. Removing this obstacle to the transfer of servicing rights will eliminate an important impediment to the entrance of additional competitors to the ranks of mortgage servicers for GSE loans, facilitate transfers where needed, and improve the GSEs overall ability to improve servicing performance and mitigate losses. As such, bifurcation should be done on all loans at little or no cost in terms the impact on the guarantee fee.

Greater Competition and Diversity – The FHFA Discussion Paper acknowledges the problems associated with having a very high percentage of GSE MSRs concentrated in a small number of mega-servicers. This concentration risk is problematic for consumers, the mortgage market and the GSEs. This concentration of MSRs reflects a similar concentration in the sale/securitization of loans with the GSEs. While there are a large number of originators of GSE loans, many of these originators sell their loans (with servicing rights attached) to the aggregator operations of one of the large, bank-owned mortgage companies. If de-concentration is to be realized, then any change to the servicing compensation structure must do two things:

- Allow servicers to set the value of MSRs and the income flow associated with those MSRs at the level necessary to permit the servicing function to remain profitable; and
- Provide incentives for additional companies to either retain servicing on the loans they originate and for new competitors to be attracted to mortgage servicing as a business and hence become acquirers of GSE MSRs or subservicers of these loans.

If mortgage servicers are mandated to set the values of their MSRs at levels that do not work for them financially, then middle tier financial institutions and mortgage companies will potentially cease retaining servicing. This will drive more servicing to the larger banks that aggregate originations for subsequent securitizations. By attaching little value to MSRs, such institutions can retain servicing and still meet the phase in requirements for capital under Basel III. This outcome would penalize smaller businesses. Larger banks would benefit at a time when this would appear to be counter to current market sentiment.

Given that there are a broad variety of business models among lenders and servicers, any change to the servicing compensation structure should take this diversity into account by providing sufficient flexibility to accommodate different sizes, core competencies, cost structures and charters.

Discussion Paper Options

The Discussion Paper sets out two options for changing the mortgage compensation structure. One option is billed as a more modest change and features a decrease in the base servicing fee together with the establishment of a reserve, which is funded by a 3 – 5 basis point surcharge for each mortgage. The second option – called a "fundamental change" in the Discussion Paper – features a significant realignment of ownership and cash flows compared to the current compensation structure. The GSEs, as master servicers, would earn an 8 basis point interest rate strip from each loan. The servicer would collect the borrower's payments and remit the 8 basis point strip to the GSE, who would in turn pay the servicer a fixed servicing fee for each performing loan being serviced (initially proposed at $10 per loan, per month for the life of the loan).

Servicers would be permitted to price an excess income strip (an interest-only or "IO strip") into the mortgage coupon, over and above the 8 basis points collected on behalf of the GSE as master servicer. The Discussion Paper offers servicers two options for this IO asset:

- it could be retained by the servicer, inseparable from the MSR, and sold only connection with the sale of the MSRs, or
- it would be legally separate from the MSR, and the servicer would be free to sell the IO strip anytime thereafter to the GSEs or any willing buyer.

While this option is radical, it leaves open and unanswered many questions regarding how loans would transition from the $10 fee for service for current loans to a new structure for nonperforming loans.

Rather than a prescriptive approach for transitioning between fee-for-service and incentive compensation for NPLs, RSC believes the more important issue is to ensure that servicers have in place capital reserves that are sufficient to finance the additional costs associated with high levels of NPLs, especially unanticipated spikes in delinquencies or defaults. We recommend that servicers be required to establish a reserve account funded by a small surcharge to the servicing fee on each loan. The reserve account would be tapped to finance NPL management once NPLs exceed the “expected” level. These spikes in NPLs could be temporary (e.g., a byproduct of a botched switch in loan servicing systems), regional (major employer closes), or cyclical (national recession).

By requiring the establishment of a reserve account, all GSE servicers would have access to capital to fund the more intensive and costly servicing actions and loss mitigation efforts required for defaulted loans. The primary servicer could draw on the reserve to support in-house enhancements, or to retain a subservicer or a specialty servicer with the high-touch expertise to address the specific situation. In addition, should a primary servicer have systemic difficulties in meeting the GSEs performance goals, the GSEs could remove certain NPLs from the servicer and tap the reserve to fund enhanced default servicing activities. This approach preserves flexibility for primary servicers to more effectively fund and manage rising NPLs themselves, while also providing the GSEs with backstop authority and funding to direct such activities, if necessary.

This approach to funding enhanced default servicing could be incorporated into either of FHFA’s proposed models for compensating performing loan servicing. We further suggest that the reserve be set at a percentage of the unpaid principal balance of the servicer’s GSE servicing portfolio.

Areas of Additional Study and RSC Recommendations

As noted, many of the details related to NPL servicing were not fully fleshed out in the Discussion Paper. Our comments in the balance of this letter will focus on identifying those areas that need additional study and consultation with the industry, as well as on additions or refinements to both options to address issues we feel were overlooked or not given sufficient emphasis.

We see a need for much greater detail in both options on the management of non-performing loans. While the FHFA and GSE teams that worked on the paper have suggested that servicers use the incentive payments and compensatory fees in the FHFA’s Servicing Alignment Initiative as a guide, there simply is not enough experience with this to allow accurate modeling of the net cash flows this would produce for companies specializing in default servicing.

For example in the reserve option we believe there needs to be greater detail around the permissible use of the funds in the reserve, the outcomes that are the objectives of the reserve fund payments, and the amounts ongoing fees and incentive payments made to achieve those designate outcomes. With respect to fee for service we see a similar lack of detail, in terms of desired outcomes for under-performing and NPLs and the fees to be paid for achievement of desired outcomes.

We encourage the FHFA to engage in a dialogue with servicers to address some of these foundational concerns, and suggest consideration of the following recommendations for the management of NPLs. At the outset we would like to urge two things:

- That primary servicers who cannot meet, or do not choose to meet, the GSEs' default servicing standards be given the option to move their NPLs to a special servicer who will be able to meet those standards.
- That enhanced servicing activities on defaulted loans be compensated through both a base servicing fee, plus incentive payments for timely and desired performance outcomes. Payments would be funded from the reserve account.

<u>Performance Incentives</u> -- In the earlier paper FHFA released in February there was some talk of NPLs being transferred to special servicers to achieve re-performance or resolution. We note that the Discussion Paper does not mention, let alone expand upon, the concept of moving NPLs from general to special servicers. We recommend that primary servicers should be encouraged to form agreements with special servicers to manage NPLs following the 61st day of delinquency. The primary servicer will retain ownership of the MSR, and financial responsibility.

As we stated previously, we believe a comprehensive set of outcomes based incentives for the management of NPLs will be a very important component of changes to the compensation structure. We cannot stress enough that these incentives should be outcomes-based rather than process-based. The interests of the GSEs or borrowers will not be served by incentives paid for meeting prescriptive process goals that reward specific actions, regardless of the effect of that action (or lack thereof) on the eventual outcome of the loan. As the guarantor, the GSEs should be focused on the outcomes of servicers' management of NPLs, not every action they take in that management.

We recommend as a good starting point that the GSEs consider the following performance incentives for NPLs:

1. No Contact Incentive – establishing productive contact with a borrower that had previously not been in contact *even if no workout is achieved*;
2. Paid in full – for loans previously 60+ days delinquent;
3. Short payoff – refinance or note sale;
4. Payment plan, modifications, forbearances or other workouts;
5. Short sale;
6. Deed in lieu; and
7. REO Disposition

In order to align the interests of the guarantor, primary and special servicer, we recommend that the compensation for these activities be based on a percentage of the loan's principal balance. For all the items in the list above, except #4, the fee should be paid in full at the time the outcome is achieved. For the items in #4, we would recommend that the fee be payable monthly, out of the payments made by the borrower, for the remaining life of the loan.

One final note we urge FHFA to clarify that the current incentives, under the Servicing Alignment Initiative, for management of NPLs will remain in place following the adoption of whatever changes are determined under this servicing compensation initiative. We believe that the current incentives should be integrated with the incentives outlined above.

Reserve Account Details – There are a number of issues we recommend be considered and addressed as part of the decision to implement a reserve account to fund management of NPLs:

1. Under what circumstances can the funds in the reserve account be accessed? We suggest that the servicer not access the reserve funds until the numbers of delinquencies in the servicing portfolio reach a certain threshold. Until that point the base servicing fee should cover actions take on NPLs.
2. Under this compensation structure when does a loan become an NPL? We recommend the 61st day of delinquency.
3. Should the reserve account be attached to the MSR and hence transfer with the MSR? We recommend that the balance in the reserve account should accrue until it reaches a pre-defined percentage of the unpaid principal balance of the servicer's GSE portfolio, and then maintained at that percentage thereafter. Outcomes-based fees on NPLs should be paid out of this reserve to the servicer performing the NPL servicing, be it a primary or special servicer. Establishing the appropriate reserve percentage will require significant modeling. The RSC would like to work with the FHFA and the GSEs begin that process.
4. Should the GSEs or the mortgage servicers control the reserve account? We suggest the reserve should be held in a trust account managed by the primary servicers subject to GSE oversight.
5. What happens if/when the reserve account is exhausted? We recommend that the guarantors pay the monthly base fee and outcomes-based incentive fees if the reserve account is exhausted.
6. Are third party fees, such as property preservation and foreclosure attorneys, payable from the reserve account? We suggest that all third-party fees that the primary servicer is currently responsible for paying from their own funds, should continued to be paid by the primary servicer from their own funds and not from the reserve account funds.

Fee for Service Details – Similarly if the fee for service option is adopted we have several recommendations of details that should be evaluated and added:

1. Establish a bright line test for when a loan goes from performing status (i.e., at $10 per loan) to NPL status (and eligible for a base NPL fee plus

incentives). We recommend that on the 61st day of delinquency a loan should be classified as non-performing and no longer subject to the performing loan fee.

2. Should servicers be required to transfer NPLs to a special servicer? If so at what point should the transfer take place? Or should the transfer be at the option of the primary servicer? Or should the option lie with the guarantor? We recommend that the primary servicer should retain the option to service in-house, or to contract with a default servicing specialist. The GSEs as guarantors would retain the right to transfer NPLs to a servicer with specialized default servicing expertise after the 90th day of delinquency.

Summary

To summarize RSC's comments, we urge that any change to the mortgage servicing compensation structure achieve 5 objectives:

a. Maintain servicer skin in the game;
b. Align servicer incentives with performance by making incentives outcome-based, rather than process-based;
c. Provide flexibility to lenders/servicers to book their MSR value at a level that reflects their cost structure by designating a specific range for the minimum servicing fee;
d. Bifurcate selling and servicing representations and warranties; and
e. Engender greater competition in the mortgage servicing arena.

We applaud the FHFA for its efforts to improve the quality of servicing and default management in the GSEs' portfolio and securities. As noted, many important details need to be further refined with respect to the movement of loans from performing to NPL status, and on the compensation and incentive structures associated with non-performing loans. We strongly recommend that the FHFA work with servicers to develop the details that will allow servicers to reliably model the revenues, costs and risks associated with any new compensation models. The RSC stands read to assist the FHFA in the next round of discussions.

Thank you for the opportunity to comment. We will be pleased to provide additional details or answer any questions you may have. I can be reached at 972-715-1022.

Sincerely,

DocuSigned by:
Amy Brandt
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Amy Brandt
Chairperson