

RESPONSE TO FHFA JOINT SERVICING COMPENSATION INITIATIVE
PREPARED BY UCM, INC.
MARCH 2011

INTRODUCTION –

In February 2011 the FHFA issued its *Servicing Compensation Initiative pursuant to FHFA Directive in Coordination with HUD – Background and Issues for Consideration* aka Joint Servicing Compensation Initiative (“JSCI”) proposing four potential changes in servicing compensation for single-family mortgages serviced for the GSEs, Ginnie Mae and FHA. In an earlier press release FHFA Acting Director Edward J. DeMarco said, “As the recent problems in managing mortgage delinquencies suggest, the current servicing compensation model was not designed for current market conditions.” DeMarco’s suggestion may be open to debate, but FHFA’s four broad proposals for restructuring servicing compensation need to be reviewed by business people familiar with the complex dynamics of the mortgage banking business, from mortgage origination to mortgage securitization and mortgage servicing for both performing and non-performing loans.

This paper will address each of FHFA’s proposals separately, but it will first discuss some overarching issues that impact either all of the proposals or certain overall concepts important to mortgage servicing and business operations.

CURRENT MSR BANK CAPITAL CALCULATION –

On page 16 of the JSCI, FHFA presents a seriously flawed calculation of the Equity required to support MSR. They overstate the Equity requirement by over 100%. The Illustrative example for a Well Capitalized bank is as follows:

MSR Fair Value	\$100
% to apply risk weighting	90%
Assets to apply risk weighting	\$90
Risk Weighting	100%
Capital Rate	10%
Equity Required	\$9

This illustration is complete and correctly shows the amount of equity required for MSR assets in a Well Capitalized bank. The current Minimum Adequate equity is 8%. Unfortunately, the FHFA goes on to overstate the Equity required for MSRs with the following illustrations:

MSR Fair Value	\$100
Assets to apply risk weighting	<u>(\$90)</u>
Equity Required	<u>\$10</u>

FHFA adds the \$10 to the \$9 and then rounds up to conclude that it’s appropriate to use a “20% capital ratio... throughout subsequent illustrations” in the JSCI.

The problem is, capital is required, but it’s not Equity because MSRs come with very substantial capital in the form of Principal & Interest float and Tax & Insurance escrows (“P&I” and “T&I”). P&I/T&I provide substantial financing or funding of the MSR investment in the form of Demand

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Deposits. Typically, for every \$100 invested in MSRs, banks will have from \$60 to \$120 in average P&I/T&I escrows on hand to fund the MSR investment. In fact, in some states, the related Demand Deposits will exceed the MSR investment. In those cases, the 8% or 9% equity requirement is only an allocation for risk reserve measurement purposes.

Unfortunately, this miscalculation of Equity required for MSR assets is misleading and grossly overstates the real equity capital required. To understand the FHFA's proposals the reader needs to understand how the Core Capital or minimum Equity is actually calculated and how the MSR investment is typically funded by banks with the related escrows deposits. One mustn't confuse Equity Capital and Debt Capital, particularly when the asset is largely self-funding.

DID COMPENSATION CAUSE THE PROBLEM? –

In a January 2011 joint letter to FHFA, Treasury Secretary Tim Geithner and HUD Secretary Shaun Donovan wrote, "The current model has not motivated mortgage servicers to invest the time, effort and resources needed to fully explore all options to help delinquent borrowers avoid foreclosure,"

This is simply not true. No matter what the compensation formula for delinquent borrowers was, most major servicers were inadequately staffed for the tsunami of problem loans that showed up on their doorstep in the last few years. The problems are concentrated in the top-ten servicers and are aggravated for those servicers that assumed or acquired the servicing of failing institutions such as Countrywide, Wachovia, Washington Mutual, IndyMac and others.

Most of the acquired portfolios tended to be highly concentrated with poorly underwritten loans and/or high risk loans, such as Option-ARMs, Interest-Only loans, extreme teaser-rate ARMs, "Liar" loans and other less desirable mortgages. By assuming those failing operations, the large, surviving banks did a service to the FDIC and the nation, but they also assumed operational demands that were well beyond anything their own well managed operations could have prepared them for.

Looking beyond the largest servicers, you'll find that most mortgage banks stayed away from the aggressive lending practices and never got into any exotic mortgage products. Even so, they experienced increased delinquencies and had to work harder with more borrowers. The increased load for these lenders was in the dozens of loans, or in the hundreds of loans for some larger banks, not hundreds of thousands, as at some of the very largest banks. Most of the servicing failures occurred at the largest, overwhelmed banks and not at the institutions that kept their mortgage operations conservative and "traditional."

Let's not forget, mortgage loan modification specialists barely existed in 2007. If there were a problem loan, it was simply handed over to the mortgage origination department and refinanced. Suddenly, starting in 2008 and growing to a peak in 2010, the industry needed thousands of specialists to handle the huge wave of problem mortgages. This is a very technical area of

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mortgage servicing, yet most practitioners were learning on-the-job. It's likely that their supervisors had little more experience in this specialized area than the new hires had.

Finally, in 2011, the overloaded segments of mortgage servicing are starting to catch up. In fact, it's likely that in late 2011 and early 2012 that the staffing will need to start scaling down, leading to layoffs and other contraction costs. Larger servicers will need their service fee during the inevitable wind down to cover the contraction costs. Servicers have reacted to an unprecedented wave of new volume, made some serious mistakes, corrected those mistakes and are beginning to catch up. Changing the servicing compensation now is reacting to an origination disaster that occurred in last decade.

Regulations and underwriting standards are in place precluding another mortgage origination debacle like the last. Current mortgage loans are being underwritten to the soundest policies, procedures and credit profile in decades. The supporting home appraisals are as conservative as ever and mortgage rates are still relatively low. The successful return of housing is critical to the economic recovery. The current mortgage production market is healthy, although volumes and margins are dropping. The issues of GSE reform and restarting the private MBS market remain. Now's not the time to experiment with mortgage servicing compensation schemes.

Where's the Fee-For-Service Table? –

Three out of four of the FHFA's proposals refer to some sort of fee-for-service ("FFS") to supplement the minimum servicing fee or make up for the lack of a servicing fee. How will that be determined and administered nationally? It's impossible to even begin meaningful discussion or modeling of a proposed servicing compensation and investment returns without a proposed fee table.

Just to provide an example of the difficulty of arriving at a fair FFS schedule, page 8 of the JSCI cites a 2007 MBA (Mortgage Bankers of America) study showing an average monthly per loan cost to service of \$8 to \$9 per loan. On a \$100,000 loan, that's 9.6 or almost 11-basis points. The cost to service loans has risen significantly since 2007 for both current and NPL (non-performing loans) because the rules and regulations have changed. New rules require earlier notification of borrowers' rights and more effort is going into keeping loans from going even 30-days delinquent.

As any parent knows, even those that never took an economics course, you get what you reward. Hence, any FFS schedule would need to reward keeping borrowers current. If you want to keep the most loans current, you give the greatest reward for the loans that are current. As loans go into delinquency, only costs should be covered.

The problem with the FFS concept is keeping the fee schedule fair and current. FHA's reimbursement schedules, for example, are woefully out of date and don't cover all the cost of maintenance, attorney's fees and other foreclosure costs, but that's "ok" because Ginnie Mae servicing pays 44-basis points instead of the 25-basis points for GSE fixed rate mortgages. The

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higher 44-basis point servicing fee compensates for lower average balances, higher expected delinquencies and unreimbursed costs to the servicer.

If a task force created the ultimate fair FFS schedule in 2012, it would surely be out of date by 2013. In 2011, the FHFA proposal quotes an extremely out of date 2007 cost studies. The first signs of the current housing crisis had just started showing in 2007. Since then, housing prices have fallen, servicing rules and regulations have tightened significantly and cost to service both current and NPL have risen significantly.

The mechanics of FFS need to be considered carefully also, yet they aren't even mentioned in the FHFA's JSCI. In a private security, there's a "waterfall" of cash distributions from the cash flows derived from the securitized mortgages. The highest rated Tiers of the receiving cash flows start receiving principal and interest payment immediately after securitization, but some portion or all of the higher risk-bearing Tiers' cash flows go to build loss reserves. The Tier's bearing the highest risks may not receive cash flows at all until a specified level of cash reserve has been built.

The loss reserves are held in Trust and a Trustee determines distributions to the security holders, servicer, master servicer and any other retained interest holder. The security sponsor enjoys upside profits when, some years down the road, the losses are less than the reserves. Will the FHFA's proposals include bond trusts to hold the funds, or what will the funding mechanisms be?

MORTGAGE RATE SETTING –

One page 14 the FHFA presents *Illustrative Model Comparison – Mortgage Rate Setting*, which is a premised on a flawed understanding of mortgage rate setting in the real world. They start their premise by pricing a loan with a 25-bp servicing fee, as follows:

	%
Treasury (rate)	4.20
MBS Spread to Treasury	<u>1.30</u>
MBS Current Coupon	5.50
Guarantor Revenue	
G-fee	0.20
Mortgage Bank Revenue	
Minimum Servicing Fee	0.25
Additional Spread	<u>0.05</u>
Total primary/secondary spread	<u>0.50</u>
Borrower Rate	<u>6.00</u>

This is actually a fairly accurate example of mortgage pricing as in effect in early 2011, except the MBS Spread to Treasury is higher than recently experienced. That Treasury/MBS spread

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might be 70-bps to over 200-bps, but it makes no difference in the originator/servicing profits because it all goes to the MBS investor.

Notice that the example shows only 5-bps of spread going to the mortgage banker after the minimum servicing fee ("MSF"). That spread is determined by market conditions. In the last few years that really meant that the margin equals what the top few mortgage banks think that they need.

If the top mortgage banks think that they need to gain market share, then the margin could actually be negative. However, in 2010 and so far in 2011 there's generally been a positive margin.

Unfortunately, all of FHFA's analysis in the JSCI is predicated on the mortgage rate staying the same, no matter what the minimum servicing fee ("MSF") or G-Fee might be. That will certainly not be the case, even if the MSF goes to zero. The margin will be determined by the mega-bankers and anyone stepping outside that model will lose market share.

FHFA's analysis does show the sensitivity to the G-Fee. If the G-Fee increases by 30-bps, then the consumer's mortgage rate will need to increase by 30-bps, or 25-bps if the mortgage banker gives up 100% of his 5-bps of origination margin. If you increase the G-Fee by 30-bps and take the MSF to zero to eliminate the MSF entirely, then the note rate still needs to be 6% in order to get the MBS investor a 5 ½% yield. Then the question becomes, "Why would anyone be a mortgage banker?"

Page 19 of the JSCI is where the erroneous assumption that mortgage rates aren't changed by changes in the MSF and G-Fee is its most misleading. By keeping the borrowers note rate at 6% in all scenarios, the analysis overstates the excess servicing to monetize. The error is amplified by using a 4-multiple to monetize excess servicing when a 2-multiple is more accurate.

These are two particularly dangerous errors in calculation. Inexperienced mortgage bankers might think that the JSCI's proposals will mean trading back-end profits for upfront profits because, according to the FHFA illustrations, the note rates always remain the same and that they'll receive the same multiple for excess servicing as they recognize for primary servicing. The actual front-end margins will be considerably lower than those presented in any of the JSCI's proposals and we'll comment further on those when we analyze each option.

HOW WILL THE G-FEE CHANGE? –

No one can seriously consider proposals to change servicing compensation without knowing what additional changes will come concurrently or soon thereafter. For instance, what will happen to the GSE's guarantee-fees ("G-fees")?

Strong rumors are circulating that Fannie and Freddie are planning G-fee increases on all new mortgages of up to an additional 30- basis points. At that level, even with a servicing fee of zero,

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mortgage rates would go up. Fannie and Freddie have already recently implemented Loan Level Price Adjusters (“LLPAs”) that charge all new borrowers at least 25-basis points. For example, borrowers with a FICO score of 700 and 20% equity in their homes are penalized another 1% in upfront cost.

Most disturbing, these increased G-fees and LLPAs are not needed to offset future losses from new mortgages being written, instead, they offset legacy losses in the Fannie/Freddie portfolios. G-fees related to new production could probably be reduced substantially from current levels because of tighter underwriting standards, more conservative appraisals and higher average FICO scores. Additionally the G-Fees are currently based on volume and not loan quality and favor the largest originators and servicers.

Mortgage rates are determined by starting with the yield that investors are willing to accept for investing in mortgages through MBS. To arrive at the mortgage rate that the consumer pays, you add the servicing fee and the G-fee and the rate impact of LLPAs and, finally, a spread for the loan originator. The consumer pays all of this. When GSEs load on costs that are unrelated to the risk attributable to the mortgage being written, then that amounts to a consumer tax.

FHFA seems to be trying to lead mortgage bankers to commit capital to a business with no return, only phantom upfront income. This assertion assumes that origination is done at a profit which is factually not true over half the time. MSR value subsidized the origination process in many past interest rate environments. Also, there seems to be a presumption that mortgage bankers will agree to lower their servicing fee without knowing what the G-fee will be. No one can even begin to calculate the “upfront cash” under these potential servicing structures without knowing how much the G-fee will increase. The proposals presented by FHFA can’t be seriously considered until we know what G-fees will be required.

TAX IMPLICATIONS –

The special tax treatment of Originated Mortgage Servicing Rights (“OMSRs”) has a huge impact. An OMSR is created when an originator sells a whole-loan mortgage to a GSE for securitization and retains the MSR. The MSR will be capitalized at fair value for book accounting purposes, but it is not recognized as an asset for tax purposes. Excess servicing is created when the total servicing compensation exceed the “safe harbor” MSF defined by the IRS. Currently the safe harbor for fixed rate GSE mortgages is 25-bps, so if 45-bps of total servicing is retained, then 25-bps will be “normal” service fees, recorded as OMSRs and 20-bps will be recorded as “excess servicing.”

Excess servicing is recorded for both book and tax so that the associated earnings are taxable. Per basis point, excess servicing has a fair value that’s only about half of primary OMSRs. This is because it has less duration and more negative convexity than OMSRs. So, if OMSRs are worth a 4-multiple, then excess servicing on the same portfolio is worth only a 2-multiple.

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The following analysis shows the vast difference in consideration value of 25-bps OMSRs versus 25-bps of excess servicing:

	<u>OMSR</u>	<u>Excess</u>
Future cash flow in bps	25	25
Value multiplier	4	2
Fair value at inception	100	50
Less tax currently payable	<u>0</u>	<u>(17.5)</u>
Net after-tax consideration @ inception	<u>100</u>	<u>32.5</u>

The net cash difference of 67.5 basis points between seemingly similar assets is huge. The difference multiplier and tax treatment makes OMSRs a much more attractive “investment”, particularly to non-bank investors, for whom cash flows are extremely important in their decision to hold MSRs.

Purchased MSRs (“PMSRs”) have a different, unfavorable, tax treatment. The IRS requires that PMSR be capitalized for tax and amortized using an arbitrary life that exceeds the actual economic life of the asset. PMSRs are not relevant to the issues surrounding new loan pricing and production, but are relevant to the resale market for MSRs.

PROPOSED “1% P&I” SOLUTION –

On page 19 of the JSCI, FHFA presents a hugely distorted model of the cash flows from their 1% P&I proposal, as follows:

Note rate	6.00
Guarantee fee	(0.20)
Minimum servicing fee	-
Excess servicing/spread	<u>(0.30)</u>
MBS Rate	<u>5.50</u>
Cash flow at origination:	
Net cost to originate	(0.88)
Excess servicing monetized	1.19
Funding of 1% of loan	<u>(1.00)</u>
Pre-tax cash flow	<u>(0.69)</u>
Tax cash flows:	
Taxable income	0.59 (sic)
Tax cash flow @35%	<u>(0.21)</u>
After-tax cash flow	<u>(0.90)</u>

What’s attractive about that? FHFA is proposing that banks invest 90 net-of-tax basis points in order to receive an unguaranteed 5.5% yield on 1% of an MBS. That’s not only a bad servicing deal, but it’s an investment deal that no sane investor would make.

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When you use realistic cash flow assumptions the situation worsens, as follows:

Note rate	5.825
Guarantee fee	(0.20)
Minimum servicing fee	-
Excess servicing/spread	<u>(0.125)</u>
MBS Rate	<u>5.50</u>
Cash flow at origination:	
Net cost to originate	(0.88)
Excess servicing monetized	0.25
Funding of 1% of loan	<u>(1.00)</u>
Pre-tax cash flow	<u>(1.63)</u>
Tax cash flows:	
Taxable income	(0.63)
Tax cash flow @35%	<u>0.22</u>
After-tax cash flow	<u>(1.41)</u>

Two major differences between this realistic pricing of the cash flows are that the note rate is adjusted assuming that the oligarchic mega bankers price in 12.5 bps of excess spread, rather than simply keeping the note rate where it is under current practice. No one knows where the note rates go, but we can all be certain that it will not stay the same. The second analysis uses a realistic value multiplier for excess servicing.

FHFA hasn't specified what servicers' loss position will be under this proposal, only saying that the P&I is "unguaranteed". That creates a liability that should be recognized in the origination process. The proposal has the GSE receiving an ongoing 20 bps G-Fee for its loss exposure. If we can assume that's risk based, then we need to apply a 2 to 4-multiple to that for the originators' retained credit risk. That results in a credit reserve requirement in the 40 to 80 bps range that should be recognized up front when the whole loan is securitized.

Also, we can't forget about the net servicing obligation, which must also be recognized up front at securitization. If there will be a FFS, then we need to know it in order to estimate and record this liability on the books.

The FHFA's *Illustrative Model Comparison – Accounting*, on page 20, is riddled with errors regarding the 1% P&I proposal, including:

- The likely note rate is overstated
- The likely excess servicing is overstated in amount and the value-multiple used is unrealistically high
- "MSR – base compensation" of 1.00% is overstated because there is no compensation element here. If you invest 1% in an MBS, then it's MBS, not servicing compensation.
- There is no accounting shown for the retained risk generated by the unguaranteed nature of the servicer's MBS investment, which is likely a negative of 40 to 80-bps.

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- There's no accounting recognition of the servicing obligation, which can't be determined without a FFS schedule

PROPOSED "3BPS AND 0BPS SERVICING MODELS –

The two proposals are essentially the same and will be considered together. It's really impossible to make any sense of these proposals without an associated FFS schedule; however, we can review the computational errors presented in the JSCI.

On page 19 of the JSCI, FHFA presents the following illustrative model of the cash flows from their 0-Service Fee proposal, as follows:

Note rate	6.00
Guarantee fee	(0.20)
Minimum servicing fee	-
Excess servicing/spread	<u>(0.30)</u>
MBS Rate	<u>5.50</u>
Cash flow at origination:	
Net cost to originate	(0.88)
Excess servicing monetized	1.20
Funding of 1% of loan	<u>0</u>
Pre-tax cash flow	<u>.32</u>
Tax cash flows:	
Taxable income	0.32
Tax cash flow @35%	<u>(0.11)</u>
After-tax cash flow	<u>.21</u>

This model completely ignores the FFS. The discounted cash flow from the FFS table will result in a value to be recorded when the mortgages are securitized. That capitalized value will show up as MSR and increase the gain on sale, assuming it's positive.

This model once again grossly inflates the value of excess servicing monetized by assuming that the note rate will remain anchored at 6% and using a 4-multiple, which is around twice the likely value for excess servicing.

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When you use realistic cash flow assumptions the cash flow situation worsens, as follows:

Note rate	5.825
Guarantee fee	(0.20)
Minimum servicing fee	-
Excess servicing/spread	<u>(0.125)</u>
MBS Rate	<u>5.50</u>
Cash flow at origination:	
Net cost to originate	(0.88)
Excess servicing monetized	0.25
Funding of 1% of loan	<u>0</u>
Pre-tax cash flow	<u>(.63)</u>
Tax cash flows:	
Taxable income	(0.63)
Tax cash flow @35%	<u>0.22</u>
After-tax cash flow	<u>(.41)</u>

In *Illustrative Model Comparison – Accounting* on page 20 there's no capitalization of the FFS cash flows associated with this proposal. With a FFS schedule the estimated future cash flows could be easily modeled. However, with this vacuum of data, we can't attempt to complete this analysis.

The known errors in the Accounting comparison for the 3 bps and 0 bps proposals are as follows:

- The likely note rate is overstated
- The likely excess servicing is overstated in amount and the multiple used is unrealistically high
- "MSR – base compensation" of 0 is understated because, hopefully, there'll be some positive value to the FFS which will require recognition at mortgage securitization.
- The excess servicing amount and capitalized value are both overstated, as discussed above.

There's a caption with asterisk saying, "Un-capitalized fair value of servicing* Recognized as incurred/earned rather than at sale into MBS." This is not consistent with current accounting rules. Servicers will calculate their future cash flows, including the cost to service, float and FFS, just like they do today. The calculation will include contractual cash flows, just like in the current servicing model. Changing the compensation from a basis point compensation to a FFS calculation has no impact on the accounting rules.

The relevant accounting rule is 860.50.30-2 of the Financial Accounting Standards Board's *Accounting Standards Codification* ("ASC") which says:

"Typically, the benefits of servicing are expected to be more than adequate compensation to a servicer for performing the servicing, and the contract results in a

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servicing asset. However, if the benefits of servicing are not expected to adequately compensate a servicer for performing the servicing, the contract results in a servicing liability. Paragraph 860-50-35-1A states that a servicing asset may become a servicing liability, or vice versa, if circumstances change. The initial measure for servicing may be zero if the benefits of servicing are just adequate to compensate the servicer for its servicing responsibilities. A servicing contract that entitles the servicer to receive benefits of servicing just equal to adequate compensation, regardless of the servicer's own servicing costs, does not result in recognizing a servicing asset or a servicing liability. A purchaser would neither pay nor receive payment to obtain the right to service for a rate just equal to adequate compensation."

The ASC's Glossary defines "benefits of servicing" as follows

- "Contractually Specified Servicing Fees

All amounts that, per contract, are due to the servicer in exchange for servicing the financial asset and would no longer be received by a servicer if the beneficial owners of the serviced assets (or their trustees or agents) were to exercise their actual or potential authority under the contract to shift the servicing to another servicer. Depending on the servicing contract, those fees may include some or all of the difference between the interest rate collectible on the financial asset being serviced and the rate to be paid to the beneficial owners of those financial assets."

Nothing in this language would exclude a FFS from the "benefits of servicing". Hence, the FFS needs to be known and included in the initial recording of the MSR asset or liability.

Because FFS does not decline over time like a fee in basis points multiplied times a declining unpaid principal balance, the duration of the MSR asset is likely to be extended versus the current MSR asset, but the negative convexity of the asset will likely be greater. Once again, one needs an actual FFS schedule before that can be definitively demonstrated. It may produce a smaller asset that could be harder to hedge due to increased convexity.

PROPOSED "12.5BPS SERVING MODEL –

This is perhaps the most viable of the four proposals in the JSCI. It's comparable to the situation in the late 1980s and early 1990s when average mortgage balances were roughly half what they are today.

As in all the other alternative proposals in the JSCI, the excess servicing amount is overstated in amount because of the unlikely assumption that note rates don't change in response to changes in minimum cost. The multiplier used for excess servicing is also overstated by around 100%.

The biggest negative to the proposal is that borrowers with lower balances will have to pay more in rate or fees to make up for potential negative cash flows. For instance, a \$100,000 mortgage might require no extra fees or higher rate, but a \$50,000 loan might need to pay another half-

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point up front. In the past, these lower balance borrowers would go into a Ginnie security and they might also in the future.

The best thing about this proposal is that bankers could accumulate roughly twice as many customer mortgages before hitting their capital limits, whatever those may be. The OCC hasn't signaled if it'll follow Basel III or stay with their current MSR limitations or propose something in the middle, but no matter what they decide, this proposal will give banks more room per customer.

ALLOW QUARTER-POINT MBS YIELD INCREMENTS –

While servicing compensation is under consideration, why not consider allowing MBS in quarter-point increments? Quarter-point versus half-point increments will:

- Reduce excess servicing and reduce the need for buy-up/buy-down grids to cover the mortgage rate to MBS rate gap.
- Hedgers that use TBA securities as hedges will have tighter hedge tolerances
- All other things being equal, mortgage rates will drop slightly
- Reduce premiums and discounts on new securities issues, where prepayment and extension risk can be major concerns for MBS buyers

This is probably only relevant if there's a reduction in the MSF. If the MSF stays at 25-basis point, the need to move to smaller bond rate increments will depend on where the G-Fee ends up and what the sum of the two totals. If it's just over 50-bps, then quarter-point yields might be desirable, even with no change in the MSF

UNINTENDED CONSEQUENCES –

All of the JSCI's proposals put more emphasis on earnings from escrows and P&I float. The most extreme proposals make almost all of the earnings dependent on escrows and P&I float. This puts non-banks at a much greater disadvantage than under the current servicing compensation structure. In an era of "too big to fail", systemic risk concentration in banks and potential Basel III capital restrictions, shouldn't we be developing, or retaining, a model that encourages non-bank participation?

Recently, there's been an increase of interest in owning MSRs from non-bank mortgage participants, such as insurance companies and former production-only mortgage banking institutions. The uncertainty caused by the JSCI has put such plans on hold recently.

Shouldn't the FHFA be encouraging a broader base of MSR ownership rather than proposing changes that will increase concentration and systemic risk in the banking system?

As mentioned earlier, moving from a basis point fee applied to the unpaid principal balance to a FFS based on the number of loans in specific categories, increases duration and negative convexity of the MSR assets. When you increase negative convexity (caused by the borrower's prepayment option on most mortgages without prepayment penalties) you increase the difficulty

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and cost to hedge the resulting asset. The reason hedging costs increase is that you generally will need to buy optionality to offset the non-linear loss propensity of the MSR asset.

The added negative convexity is the opposite impact than the JSCI's stated objective to, "Minimize balance sheet volatility and capital intensity." The current servicing compensation model provides a better balance between fees and IO-like behavior, at a lower cost to hedge.

Another stated goal of the JSCI is to, "Maximize predictability of prepayment behavior" for MBS investors. Since some of the proposed models move cash flows to the front of the mortgage cycle, to origination and securitization, servicers will have greater incentive to refinance mortgages than in the current model. That will certainly increase prepayment propensity and introduce less predictable prepayment behavior for investors. It will take years to develop new prepayment estimation models and while that's happening investors will demand extra yield to offset the added uncertainty.

CONCLUSION –

Without a FFS schedule and the new G-Fee, it's impossible to reach any meaningful conclusion about any of these proposals. As soon as those numbers are available we could easily model and value these proposals using current, realistic assumptions. However, it is safe to say that none of the objectives set forth at the beginning of the JSCI were met by any of the proposals.

Several errors run throughout the JSCI and need to be removed or corrected. These include:

- Incorrect accounting assumptions about whether MSR is capitalized or not.
- Overstated multiples for the value of excess servicing
- The equity required by banks holding MSRs needs to be properly calculated and debt capital properly differentiated from equity capital
- In the 1% P&I proposal we need to understand the loss priority that the servicer will assume for its "non-guaranteed" 1% P&I interest.
- If there's going to be a zero-fee proposal or near-zero-fee proposal, just pick one and flesh it out more. Since 3-bps is below the true cost to service, the question of why would anyone commit resources to a breakeven business remains.
- The assertion that the earnings from the escrow balances covers the cost to service is also not true. Today, the OAS of escrow balances is negative.

Finally, servicing compensation is not the cause of recent servicing disappointments. It seems likely that the tsunami of NPLs, had much to do with overloading systems and overwhelming staff at the largest servicers and they experienced the most trouble.

These problems will probably be substantially worked out by 2013, so why are we proposing wholesale changes to go into effect in 2012? The proposals will only impact future production and have no value in addressing our legacy problems that'll take the next three years to bring under control.

RESPONSE TO FHFA JOINT SERVICING COMPENSATION INITIATIVE
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The sustainability of residential mortgage finance is at risk. The consumer will ultimately pay for any changes. If we're going to pursue comprehensive reform, then we need to work through complete ideas that can be modeled and discussed. The current JSCI doesn't meet that test.

David C. Stephens
Dave@ucm-inc.com

R. Austin Tilghman
Austin@ucm-inc.com