



December 21, 2011

Mario Ugoletti
Senior Advisor to the Office of the Director
Federal Housing Finance Administration
1700 G Street, NW
4th Floor
Washington, DC 20552

Dear Mr. Ugoletti,

The Securities Industry and Financial Markets Association (“**SIFMA**”)¹ is pleased to respond to the Federal Housing Finance Administration’s (“**FHFA**”) *Alternative Mortgage Servicing Compensation Discussion Paper* (“**Discussion Paper**”). Our comments are focused in this document on the discussion around servicing in the Agency MBS markets. SIFMA appreciates the openness and receptivity of FHFA over the course of the last number of months as this Discussion Paper was developed. This provided an opportunity for market participants to understand FHFA’s motivations and to be better able to respond to this Discussion Paper.

SIFMA places a central focus on the importance, and the necessity of maintaining the liquidity of the To-Be-Announced (“**TBA**”)² markets for Agency Mortgage Backed Securities. Given that the Agency markets currently fund nearly all residential mortgage credit, it is critical that any changes to the structure of the securities that trade TBA be undertaken extremely carefully, with a view towards not impairing the ability of these markets to fund mortgage credit origination given the lack of a meaningful alternative funding source at this time. These markets are by far the largest and most liquid secondary market for mortgage loans, and are critically important to meeting the credit needs of American consumers. Among other things, homogeneity and stability are key underpinnings of this market. Securities traded in these markets must be fungible, and the rules cannot change repeatedly, and must only change for thoroughly documented benefits which exceed costs. The Discussion Paper, therefore, must be viewed in the context of its impact on the TBA market.

The Discussion Paper outlines four stated goals:

- (1) Improving service to borrowers,*
- (2) Reducing financial risk to servicers,*
- (3) Promoting the liquidity of the TBA markets, and*

¹ SIFMA brings together the shared interests of hundreds of securities firms, banks and asset managers. SIFMA’s mission is to support a strong financial industry, investor opportunity, capital formation, job creation and economic growth, while building trust and confidence in the financial markets. SIFMA, with offices in New York and Washington, D.C., is the U.S. regional member of the Global Financial Markets Association (GFMA). For more information, visit www.sifma.org.

² For a longer discussion of the TBA markets, please see pages 4-20 of this document: <http://www.sifma.org/issues/item.aspx?id=8589935933>.

(4) Promoting competition in servicing.

We strongly support these goals as laudable and important, and we will review the proposals in the paper relative to them.

Summary of SIFMA's Views, and a Guiding Principle

SIFMA's members who are active in the Agency MBS markets have significant concern about the impact of both of the proposals discussed in the Discussion Paper on the liquidity and pricing in the TBA markets and their impact on mortgage borrowers. SIFMA feels strongly that before FHFA takes any further action regarding the GSE's servicing requirements, that a comprehensive dialog should be initiated with secondary market participants.

The principle that underlies this view is that ***changes to the structure of mortgage servicing compensation should not affect the cost of credit to mortgage borrowers.*** We are concerned that both the fee-for-service and reserve fund approaches described in the Discussion Paper have the potential to do that, to varying degrees. This is primarily because each approach would not meet the third goal outlined above; instead of promoting the liquidity of TBA markets, our members believe they would diminish liquidity. Such a diminution of TBA market liquidity would result in increased costs to borrowers.

This is not to say that SIFMA opposes the principle of change in mortgage servicing generally. SIFMA supports the careful implementation of changes, if justified, only after a thorough examination of the costs, benefits, impact, and sequencing of them. As we will discuss further below, ***SIFMA believes the correct approach at this time is to retain the current servicing compensation regime for loans securitized by the Agencies, and continue to discuss with market participant changes that can be made in a manner that does not disrupt liquidity and impact costs for mortgage borrowers.*** In any case, SIFMA's members strongly reject the fee-for-service proposal.

High-Level Introductory Points

- ***Uncertainty of the Future Cost of Servicing***

We note that it is difficult, if not impossible, to predict with any degree of certainty the expected cost of servicing two years forward. The list of current initiatives that will likely impact the cost of servicing includes but is not limited to: the development of national servicing standards³, a 50-state attorney general effort⁴, bank regulator consent orders⁵, federal legislation related to mortgage servicing⁶, local legislation related to mortgage servicing⁷, future changes to HARP, HAMP, and potential new government initiatives that may require changes to staffing, systems, or both. Given all of this, it is unclear how one would be able to define what is adequate servicing compensation, as the future cost of servicing is so uncertain.

³ See statement of Julie Williams before House Financial Services Committee:

<http://financialservices.house.gov/UploadedFiles/070711williams.pdf>

⁴ See press release from Iowa's Attorney General:

http://www.state.ia.us/government/ag/latest_news/releases/oct_2010/robo_signing.html

⁵ See statement from OCC: <http://www.occ.treas.gov/news-issuances/news-releases/2011/nr-occ-2011-139.html>

⁶ See, e.g., S.967 introduced by Sens. Olympia Snow (R-ME) and Jeff Merkley (D-OR.) on May 12, 2011, among others.

⁷ E.g., recent ordinances passed by the Chicago City Council, Springfield Massachusetts, Las Vegas, and various other state and local governments.

- *The Importance of Servicer Compensation to Agency MBS Investors*

Compensation to servicers, in this case the 25 basis point strip of interest income received by servicers of TBA eligible pools, is viewed as an incentive aligning mechanism by investors in MBS that trade in TBA markets. Servicers need to have long-term skin in the game as mortgages are longer duration assets. Generally speaking, reductions in servicing compensation are viewed as actions that decrease this alignment; a servicer's incentive to retain the servicing of a loan is decreased as its compensation for doing so is decreased. In markets where nearly every security trades at a premium (that is, above par), it is critical that servicers have appropriate incentives to retain borrowers and not promote or allow churning of portfolios. Servicing has a significant ability to impact returns for investors.⁸ In the past, secondary market participants have opposed proposals that would meaningfully reduce servicer compensation without concurrent actions that benefitted MBS investors. At the risk of generalizing, investors in Agency MBS generally view reductions in servicer compensation as events that would reduce the value of MBS pools. This, of course, implicates the value of those pools and the cost of credit for borrowers.

The Fee-For-Service Proposal (FFS)

A regime discussed in the proposal would implement a fee-for-service approach, whereby servicers would receive a set dollar fee per loan for performing loan servicing, and then additional compensation for distressed loans. This proposal would represent a dramatic, near-total reduction in compensation for performing loan servicing (which, of course, would impact the vast majority of GSE loans). The proposal notes that the level of base compensation could be changed as needed.

We next review this proposal in the context of FHFA's goals.

- *Goals 1 and 4: Improving service to borrowers and Promoting Competition in Servicing*

Theoretically, a better alignment of compensation to actual cost could improve service to delinquent borrowers, assuming that servicers appropriately utilized the new compensation structure to develop their internal processes and systems. However, we have been in contact with a number of smaller servicers directly and indirectly (through associations which represent their interests), and expect that the FFS approach would severely impede the ability of many of these firms to service loans economically. Very low compensation naturally favors those participants who are able to take advantage of economies of scale. Therefore we would expect many small servicers to exit the market, with competition and innovation to be materially reduced.

In discussions over the course of the year we have understood that a goal of the working group may be to entice non-traditional firms into the mortgage servicing business, such as large entities traditionally focused on information technology. According to this idea, these entities would be able to service loans in a highly automated, low touch manner for a minimal ongoing fee, and provide competition for the existing large servicers. We raise two points for consideration here. First, it is unclear if automated, low touch servicing is a desirable goal from a public policy perspective at this time. Second, we question whether the entry of one or two large competitors would offset the loss of potentially hundreds of smaller community banks and other small servicers. It may be viewed as a perpetuation, if not strengthening, of the current concentration.

⁸ Research has shown that levels of retained servicing impact prepayment speeds on underlying pools. See, e.g., JPMorgan *2012 Securitized Products Outlook* (November 23, 2011), Bank of America *Securitization Weekly* (January 28, 2011),

- *Goal 2: Reducing Financial Risk to Servicers*

Given the very low level of compensation, the FFS approach should reduce or eliminate the need for a servicer to book a mortgage servicing right asset (MSR). Some servicers, but not all, would likely view this as beneficial, according to our understanding. In any case, SIFMA believes any value of this (which as noted might depend on the servicer) pales in comparison to its cost in terms of competition reduction, destruction of liquidity in the TBA market (discussed below), and potential for increases in mortgage costs for borrowers. Looked at from another angle, FFS may materially increase financial risk to a number of servicers. The FFS approach would require servicers to be far more precise with respect to estimating the future cost of servicing (recall the discussion of the uncertainty of this cost above). If servicers fail to estimate the future cost appropriately, the much smaller revenue stream under FFS could essentially lock them into a negative basis trade. Thus more servicers could fail, resulting in mispriced servicing that may not be able to be transferred economically.

- *Goal 3: Promoting the liquidity of the TBA markets*

SIFMA's Agency MBS investor and market maker members believe the implementation of this proposal would be **very** destructive to the liquidity in TBA markets and strenuously urge FHFA to reconsider the application of this proposal to Agency MBS markets.

Given that more than 95% of the loans that collateralize GSE MBS are performing,⁹ the FFS model would reduce compensation for nearly all loans collateralizing TBA MBS and impact all MBS investors. We noted above investors' significant concerns with churning in reduced servicing environments – these concerns would arise to the strongest extent under a FFS model, where servicers would have very little financial incentive to retain the servicing of a given loan. We also note that the capital benefit from refinancing existing MSRs into the new FFS model would create incentives to expedite the refinancing of existing loans (serviced under the current 25bp strip regime) that would be destructive to the value of existing MBS. A FFS model does not provide significant long-term alignment between servicers and MBS investors. Investors therefore view this proposal all around as negative for liquidity in MBS; it represents a value transfer from investors to servicers, with no compensation for that value lost.

Another concern with the FFS approach is that there is no reasonable way in which securities collateralized by loans under the FFS approach could be considered fungible with existing 25bp strip securities. In other words, a move to this approach would immediately bifurcate the TBA market. Liquidity for existing securities would be impaired, and liquidity for the new securities would be limited, given the lack of a track record of performance, lack of supply, and other factors. We expect that the mere announcement of a move to this program at some point in the future would set in motion a process of declining liquidity that would immediately begin to raise the cost of mortgage credit to borrowers.¹⁰

⁹ This estimate is based on Fannie Mae and Freddie Mac October 2011 Monthly Volume Summaries.

¹⁰ In addition to generally decreasing liquidity in the TBA market because of less attractive security performance, this could also decrease liquidity in the TBA market due to a shift in the investor base out of the TBA market and into the less liquid structured sectors such as IOs, inverse IOs and other derivative products as risk and reward is reassessed. This shift would not replace the liquidity lost in the pass-through sector, rather, it would further decrease liquidity in TBAs if investors became less active in TBAs.

In conclusion, SIFMA members strongly oppose the implementation of the FFS approach to servicer compensation. The FFS proposal fails on each of FHFA's four stated goals: it is unclear that service will improve, and it appears more likely that service may be reduced; it will increase financial risk to some servicers, not decrease financial risk; we expect this approach would severely reduce, not promote, the liquidity of the TBA markets; and we expect the FFS approach would reduce, not promote, competition in servicing. The imposition of the FFS approach would be a severely negative event for Agency MBS markets, and would result in increases to the cost of credit for mortgage borrowers.

The Reserve Account Approach (RA)

The other proposal in the Discussion Paper would implement a regime whereby servicers continued to be compensated with a strip of income based on the balance of the loans in a pool (from 12.5 – 20bp) and a reserve account would be created (funded by 3-5bp of the borrowers payment), intended to cover costs for servicing non-performing loans. This proposal would represent a less dramatic change from the current regime. When compared to the FFS approach, the RA approach would appear to avoid some of the most serious pitfalls of that approach, but it is not free from concerns.

- *Goals 1 and 4: Improving service to borrowers and Promoting Competition in Servicing*

The reserve account proposal should not disadvantage as many small servicers as FFS given that the income strip would remain at a medium level, but could have some impact on the ability of some servicers to service economically and could cause some to exit the business. In part, this would depend on where the compensation level was set. We do not see how this proposal would increase competition. We therefore view it as neutral or marginally negative for competition. It is likewise unclear what would be the specific benefit this proposal would confer upon borrowers, compared to the current regime.

- *Goal 2: Reducing Financial Risk to Servicers*

The reserve account approach would likely reduce the amount of MSR servicers would need to book. Some servicers, but not all, would view this as beneficial according to our understanding. In any case, SIFMA believes the value of this is exceeded by the cost of the diminution of liquidity in the TBA market, and potential for increases in mortgage costs for borrowers.

- *Goal 3: Promoting the liquidity of the TBA markets*

In terms of its impact on servicer incentives to refinance, the RA proposal would have a smaller impact than FFS, but that is not to say it would have no impact. Reductions in servicer compensation will increase incentives to refinance. Here, it is important to recall that directionally the impact of increased refinancing incentives for servicers will always be viewed as a negative by investors in premium-priced Agency MBS.

Our members also have concerns that securities issued under the RA approach may not be considered fungible with current production under the 25bp approach and therefore may bifurcate the TBA market at least for a period of time. To the extent that base compensation remained at the maximum of the proposal, 20bp, this would be less likely, but it is not certain in any case. However, if different servicers were able to set different levels of compensation, this would likely be another

factor that would need to be analyzed to determine performance expectations. It would increase heterogeneity of MBS pools. Given that the TBA market relies on uniformity and homogeneity, this is a negative for the liquidity of the markets.

Overall, we believe the implementation of this approach as proposed would be a negative for Agency MBS markets, and therefore would increase costs for mortgage borrowers.

Recommendations for Moving Forward

As discussed above, our guiding principle is that mortgage borrowers should not suffer increased costs due to changes in the compensation of servicers. To the extent that Agency MBS investors view Agency MBS as less valuable, this is what will happen. Both structures proposed in the Discussion Paper are likely to harm TBA markets and increase borrowing costs. In particular, implementation of the FFS approach would severely compromise the liquidity of the TBA market.

FHFA should continue to explore this topic and further determine, in consideration of the broad-scale credit quality implications of many legislative and regulatory mandates now enacted or under review, if there are demonstrably justified ways to achieve some of the goals of this project without doing so at the expense of Agency MBS investors or increasing the cost of mortgage credit for consumers. This could involve additional changes that would act in the opposite direction of the incentives created by reductions in compensation, or other actions that would promote the liquidity of Agency MBS markets. SIFMA and its members stand ready to undertake a long-term and meaningful dialog and plan to engage FHFA further on these issues.

Please do not hesitate to contact Richard Dorfman at 212-313-1359 or Chris Killian at 212-313-1126 with any questions, comments, or to further discuss these important issues.

Sincerely,



Richard A. Dorfman
Managing Director, Head of Securitization



Chris Killian
Managing Director