Legislative and Regulatory Activities Division
Office of the Comptroller of the Currency
400 7th Street S.W.
Suite 3E–218
Mail Stop 9W–11
Washington, DC 20219

Ann E. Misback
Secretary
Board of Governors of the Federal Reserve System
20th Street and Constitution Avenue N.W.
Washington, DC 20551

Robert E. Feldman
Executive Secretary
Attention: Comments/Legal ESS
Federal Deposit Insurance Corporation
550 17th Street N.W.
Washington, DC 20429

12/20/2017

RE: Simplifications to the Capital Rule Pursuant to the Economic Growth and Regulatory Paperwork Reduction Act of 1996 (OCC Docket ID OCC–2017–0018, RIN 1557–AE10; FRB Docket No. R–1576, RIN 7100 AE–74; FDIC RIN 3064–AE59, RIN 3064–AE66)

Ladies and Gentlemen:

This letter is submitted by the Mid-Size Bank Coalition of America ("MBCA") in response to the Notice of Proposed Rulemaking on Simplifications to the Capital Rule Pursuant to the Economic Growth and Regulatory Paperwork Reduction Act of 1996 ("the Proposal"),[1] and specifically with respect to those aspects of the Proposal that apply to mortgage servicing assets ("MSAs"). Founded in 2010, MBCA is a distinct and singularly focused "self-help" organization for mid-size banks that has the direct involvement of its members' CEOs and most of their management committee members. MBCA advocates for, champions, and serves as a resource to America's mid-size banks. MBCA's eighty-four member banks average less than $20 billion in size and serve customers and communities through more than 10,000 branches in all 50 states, the District of Columbia, and three U.S. territories.

[1] Simplifications to the Capital Rule Pursuant to the Economic Growth and Regulatory Paperwork Reduction Act of 1996, 82 Fed. Reg. 49,984 (proposed Oct. 27, 2017) (to be codified at 12 C.F.R. pts. 3, 217, 324).

MBCA appreciates the regulators' willingness to adjust the capital rules but recommends that the threshold for 100% deduction from capital be increased above the proposed 25% and the risk weighting reduced to no more than 130% to more appropriately address MSAs.

Mortgage lending is an important line of business for many community and mid-size banks. As has been widely reported, the ability of these banks to make mortgage loans has been significantly negatively impacted by the series of rules on mortgage lending growing out of the Dodd-Frank Act. The onerous Basel III capital rules imposed on MSAs ("MSA capital rules") have, for a number of community and mid-size banks, exacerbated this problem by making it difficult economically to make mortgages and retain servicing rights. The close personal relationship that community and mid-size banks have with their customers is a cornerstone of their business models and central to their ability to compete with large banks and non-banks. One of the most important services these banks can offer their customers is the direct servicing of their mortgage loans. The importance of this servicing to bank customers has been highlighted by the well-publicized problems large servicers had during the financial crisis. Federal bank regulators on numerous occasions have emphasized the importance of providing excellent customer service to consumers in servicing their mortgages, exactly the kind of service small and mid-size banks have been providing; yet the onerous MSA capital rules have undermined the ability of community and mid-size banks to offer this important service.

In addition, for a number of community and mid-size banks, mortgage servicing has become an important line of business in and of itself. These banks have provided a valuable customer service, especially during the financial crisis, and they continue to do so. It is notable that these banks did not have the high-profile service problems that beset large servicers and that resulted in a number of enforcement actions. However, competing in the mortgage servicing business requires scale; and the MSA capital rules -- which contain, first, an onerous 10 percent threshold based on a bank's common equity tier 1 capital level above which the amount of MSAs must be subtracted from common equity tier 1 capital and, second, a very high 250 percent risk weighting -- disproportionately impact banks with servicing portfolios that are large relative to the size of their balance sheets. In fact, the MSA capital rules make it virtually impossible for small and mid-size banks to maintain the scale to compete in this business. While the Proposal is a significant improvement over the current rule, it still would make it difficult for small and mid-size banks in the long run to maintain a viable, competitive servicing business.

A clear result of the MSA capital rules is that servicing business has been driven from banks, particularly small and midsize banks, to nonbanks,[2] and this movement would have accelerated if the

---

[2] See, for example, a GAO report on nonbank servicers, which found that a growing number of the largest services are nonbank servicers. U.S. GOV'T ACCOUNTABILITY OFFICE, GAO-16-278, NONBANK MORTGAGE SERVICES: EXISTING REGULATORY OVERSIGHT COULD BE STRENGTHENED 10 (2016). See also the 2014 Annual Report of FSOC, which states that "in the case of nonbank mortgage servicing companies, a large amount of mortgage servicing rights (MSRs) have been sold to nonbank mortgage servicing companies in recent years." The same report noted that "many banks sought to reduce holdings [of MSAs] subject to enhanced capital requirements that begin to go into effect in 2014." FINANCIAL STABILITY OVERSIGHT COUNCIL, 2014 ANNUAL REPORT, at 10, 54 (2014).

rule's phase-in had not been suspended. The restrictive threshold and risk weighting is forcing banks to sell MSAs they would otherwise retain and to do so in a small window of time that will adversely affect the price that banks will obtain for their MSAs. This movement is not just a problem for those small and midsize banks for which servicing is a profitable and safe business line; it especially is a problem for the many consumers who want these banks to do their servicing because of the banks' strong record of customer service in this field. Often MSAs are being bought by hedge funds and other nonbank entities, which may have only a short term profit interest in them, are not as experienced as banks, are less able to manage risk, and are not subject to all the same rules and oversight that banks are. The GAO, in its report on nonbank servicers, concluded that existing regulatory oversight of these nonbanks should be strengthened.[3]

THRESHOLD FOR APPLICATION OF THE RULE:

MBCA strongly supports applying the proposed changes to all banking organizations that are not subject to the advanced approaches of the regulatory capital rule. While, as discussed further below, MBCA believes the MSA capital rules were based on outdated premises about the riskiness and liquidity of MSAs, there are two additional reasons for ensuring that all small and mid-size banks are covered by the final new capital rule for MSAs.

First, in order to compete in this business, a degree of scale is needed that would be impossible for such banks to maintain under the draconian existing rules. As a practical matter, the MSA capital rules -- especially the 10% of common equity tier 1 capital threshold, which acts as a cliff -- mean that these banks must cease having MSAs as a line of business. Obviously, that 10% is a much larger absolute number for the biggest banks and therefore does not so prevent them from attaining the necessary scale.

Second, it was never appropriate to apply the Basel III rules on MSAs beyond the largest internationally active banks. In the international negotiations, Basel III capital rules were only intended to be applied to these largest banks in the first place. However, the U.S. bank regulators chose to apply a number of the Basel III rules to all banks. Even if it is assumed that may have made sense in limited instances, it never made sense with respect to MSAs for two reasons. First, none of the other countries involved in the negotiation process have a mortgage system like that of the U.S., and therefore none of them have, to any meaningful extent, MSAs, as the regulators' own report to Congress on the MSA capital rules ("the Report") noted.[4] Second, MSAs were included in a broader category of intangible assets for applying capital rules although MSAs are materially different in terms of valuation and liquidity from other intangibles. Thus the rules for MSAs were negotiated in an international process that did not provide an opportunity for an informed discussion of the

---

[3] U.S. GOV'T ACCOUNTABILITY OFFICE, *supra* note 2, at 49.
[4] The regulators' report stated: "In discussions with supervisory authorities from other countries, they noted that their supervised firms have negligible ratios of MSAs to CETI capital." The report noted that even these negligible amounts were likely attributable to U.S. operations of foreign banks or were associated with acquisitions. BD. OF GOVERNORS OF THE FED. RESERVE SYS., FED. DEPOSIT INS. CORP., OFFICE OF THE COMPTROLLER OF THE CURRENCY, NAT'L CREDIT UNION ADMIN., REPORT TO THE CONGRESS ON THE EFFECT OF CAPITAL RULES ON MORTGAGE SERVICING ASSETS 41 (2016) [hereinafter THE REPORT].

appropriate capital rules for MSAs, much less for the appropriate rules on MSAs for small and mid-size banks.

While the MSA capital rules were put out for comment by the U.S. regulators as part of the comment process on the much broader Basel III proposal, the MSA rules, as applied to small and mid-size banks, were such a minor part of that proposal that it is clear the proposed MSA rules as so applied were not given the review at that time that they should have received. It is therefore appropriate that the regulators are now reviewing those rules and making adjustments in the form of this current proposal and comment process. It is also appropriate that the adjustments in the final rule be applied to all small and mid-size banks.

MSA RISK TO BANKS IS LIMITED:

MBCA believes that historically the bank regulators overstated the risk of MSAs. The MSA capital rules were finalized without adequate consideration and furthermore were based on an out-of-date understanding of the valuation and liquidity of MSAs. In fact, in recent years the ability of banks to value MSAs and the liquidity of the market for them have increased considerably. Congress was also concerned that the MSA capital rules for small and mid-size banks were not based on a full understanding of the riskiness and liquidity of MSAs and therefore included a provision in the Consolidated Appropriations Act, 2016 that required the Report by the regulators to address, among other things, those issues.[5]

In the Report, the regulators cited "the high level of uncertainty regarding the ability of banking organizations to realize value from these assets, especially under adverse financial conditions." as justification for the MSA capital rule.[6] Yet the Report, itself, does not support this conclusion. To the contrary, while the Report's conclusion still raises questions about the riskiness and liquidity of MSAs, the Report, itself, shows that there are widely used methods to value MSAs and that there is an active market for them. As to the statement, "especially under adverse financial conditions," the financial crisis, which was largely a result of severe problems in the mortgage market, provided the most adverse financial conditions for MSAs that one could imagine; and yet the MSA market continued functioning and liquid, and valuations were obtainable.

It is quite clear that there are well-functioning markets for MSAs. While MSAs are different in terms of pricing mechanisms and liquidity from some bank assets, such as government and highly rated corporate and municipal bonds, a comparison to bank loans is instructive. MSAs are not homogeneous; yet MSAs are valued and priced all the time. Banks that have material amounts of MSAs are required to obtain regular valuations for accounting purposes to ensure they are not being overvalued. Most bank loans, other than conventional mortgages, are also not homogeneous, and there is significant complexity to valuing and pricing them. In fact the ability to value and price MSAs

[5] Section 634 of the Consolidated Appropriations Act, 2016, Pub. L. No. 114-113, 129 Stat. 2242 (2015), required the study to include, among other things, the risk to banking institutions of holding MSAs; the history of the market for MSAs, including during the financial crisis; and the ability of banking institutions to establish valuations for MSAs.

[6] THE REPORT, *supra* note 4, at 2.

and the liquidity of the market for buying and selling MSAs are superior to that of many types of bank loans that are not subject to the level of capital requirements in the MSA capital rules or even in the Proposal. For example, commercial loan rules also require specific loan-by-loan underwriting by the buyer and generally are not subject to pool fair value analysis, as MSAs are.

For many smaller banks, MSAs also provide a natural hedge to interest rate risk, one of the most important risks that banks face. As interest rates rise, the value of loans and securities in a bank's portfolio generally decrease. However, as interest rates rise, the value of MSAs generally increases because the rate of prepayments on the underlying mortgages decreases. Furthermore, banks that hold MSAs as a separate line of business generally separately hedge their MSAs, further limiting the risk to the bank of holding MSAs.

It is also noteworthy that -- during the worst period for bank failures since the Great Depression -- there was only one failure identified in the Report that was attributable in part to MSAs. The Report states that in the period 2007 to 2015, according to the Material Loss Reviews, there were only four banks where MSAs were a "factor contributing to the failure" of an institution, and in only one of those were MSAs a "significant" factor.[7] That is four institutions out of 518 failures during that period and out of 66 failures where the institution had MSAs on its books at the time of failure. Since this was a time of crisis when having strong exposure to real estate markets would most likely have put significant financial pressure on any bank, and since having MSAs on the books would indicate a high likelihood of significant mortgage lending, this limited number of problems would seem to show the MSAs, in fact, held up well under very severe adverse circumstances. This is especially true when the impact of MSAs on those four banks is studied in more detail in the Material Loss Reviews. Those Reviews show that three of the banks, in fact, clearly failed for other reasons not related to MSA portfolios.[8] Two failed because of over-concentration in risky commercial real estate lending, and one failed because of its large risky mortgage lending portfolio. In the one bank where the bank "failed, in part," because of its MSA portfolio, the real reason was not the asset itself, but rather very significant failures in managing and hedging the portfolio in a small, $70 million asset bank.[9]

This very limited record of failures where MSAs were even mentioned in the Material Loss Reviews should be considered in the context of the factors that led to 518 failures and the less onerous capital rules that are applied with respect to asset categories that caused almost all those failures.[10] In that context, the 250% risk weighting for MSAs in the Proposal is punitive and too high,

---

[7] *Id.* at 15.

[8] U.S. DEP'T OF THE TREASURY, OIG-11-072, AUDIT REPORT, SAFETY AND SOUNDNESS: MATERIAL LOSS REVIEW OF CHARTER BANK (2011); U.S. DEP'T OF THE TREASURY, OIG-CA-10-009, AUDIT REPORT, SAFETY AND SOUNDNESS: MATERIAL LOSS REVIEW OF UNION BANK, NATIONAL ASSOCIATION, (2010); U.S. DEP'T OF THE TREASURY, OIG-09-039, AUDIT REPORT, SAFETY AND SOUNDNESS: MATERIAL LOSS REVIEW OF DOWNEY SAVINGS AND LOAN, FA (2009).

[9] U.S. DEP'T OF THE TREASURY, OIG-11-016, AUDIT REPORT, SAFETY AND SOUNDNESS: MATERIAL LOSS REVIEW OF AMERICAN NATIONAL BANK (2010).

[10] The GAO study of the causes of bank failures during the financial crisis strongly supports this point. MSAs are not even mentioned in the report, which covered failures in states that had ten or more failures. To the contrary, the report concludes that "failures of small and medium-size banks were largely associated with high

especially compared to the weighting of 130% in the Proposal for high volatility acquisition, development, or construction loans ("HVADC loans"). No other asset receives such a punitive risk weighting, and in fact most assets are risk weighted at 100%.

MBCA RECOMMENDATIONS:

MBCA greatly appreciates the action of the federal bank regulators to suspend the phase-in of the existing MSA capital rules and to issue the new Proposal for those rules. For the reasons discussed above, MBCA strongly supports the applicability threshold in the Proposal, which would apply the final changes in the rule to all banking organizations not subject to the advanced approaches of the regulatory capital rule.

MBCA also strongly supports the elimination of the requirement for a deduction from common equity tier 1 capital of the aggregate amount of MSAs, temporary difference DTAs, and significant investments in the capital of unconsolidated financial institutions in the form of common stock that exceeds 15 percent of common equity tier 1 capital. These three types of assets are very different and have no correlation, and therefore they should not be placed together in one category.

MBCA appreciates the regulators' willingness to increase the 10% threshold for 100% deduction from capital for MSAs, which is overly restrictive, but is concerned that the proposed 25% does not go far enough. Even at 25 percent, the threshold still operates as a cliff, since the capital requirement for MSAs held that exceed the threshold is so onerous that it makes holding those additional MSAs uneconomic. Furthermore, any set percentage is arbitrary, and the use of such thresholds that create cliff effects is inconsistent with approaches to supervision and capital requirements used by regulators with respect to other type of assets. One solution to this problem would be to implement an alternative wherein banks with a strong MSA risk management program could use an alternative approach, in place of a threshold, based on value at risk measurements net of associated hedge positions. If the regulators continue to believe that a specific threshold is needed, MBCA recommends that the threshold be increased at least to 50% so that smaller and mid-sized banks will not be forced to sell MSAs simply because of the arbitrary threshold.

MBCA further urges the regulators to decrease the 250 percent risk weighting applied to MSAs. We believe, for the reasons discussed above, that the 250 percent is too high given the limited risk MSAs present, especially when compared to the risk weighting applied to other types of real estate assets, some of which proved to be considerably more risky in practice than MSAs during the financial crisis. MBCA suggests that the risk weighting for MSAs should be no more than 130 percent. That 130 percent is the risk weighting applied to HVADC loans under the Proposal, and it cannot reasonably be argued that MSAs are more risky or less liquid than HVADC loans.

---

concentrations of CRE loans, and in particular, ADC loans, and inadequate management of the risks associated with these loans." U.S. GOV'T ACCOUNTABILITY OFFICE, GAO-13-71, FINANCIAL INSTITUTIONS: CAUSES AND CONSEQUENCES OF RECENT BANK FAILURES 17 (2013).

Finally, MBCA appreciates that the Proposal has as one of its primary objectives the simplification of the capital rules addressed in the Proposal. MBCA supports this objective and notes that the current rules addressed by the Proposal are unnecessarily complex and difficult to interpret in practice. MBCA urges that the capital rules for MSAs be kept as simple and straightforward as possible.

MBCA appreciates the opportunity to comment on this Proposal.

Sincerely,

[redacted]

Brent T. Tjarks
Executive Director
Mid-Size Bank Coalition of America