



December 22, 2017

Office of the Comptroller of the Currency
Legislative and Regulatory Activities Division
400 7th Street SW., Suite 3E-218, Mail Stop 9W-11
Washington, DC 20219
Docket ID OCC-2017-0018; RIN 1557-AE10

Board of Governors of the Federal Reserve System
Ann E. Misback, Secretary
20th Street and Constitution Avenue NW
Washington, DC 20551
Docket No. R-1576; RIN 7100 AE-74

Federal Deposit Insurance Corporation
Robert E. Feldman, Executive Secretary
Attention: Comments/Legal ESS
550 17th Street NW
Washington, DC 20429
RIN 3064 AE-59

RE: Simplifications to the Capital Rule Pursuant to the Economic Growth and
Regulatory Paperwork Reduction Act of 1996
Docket ID OCC-2017-0018

Gentlemen and Ladies:

I am writing on behalf of the Board of Directors and management of HomeStreet Bank to comment on the recent Notice of Proposed Rulemaking issued by the Office of the Comptroller of the Currency, the Federal Deposit Insurance Corporation and the Board of Governors of the Federal Reserve (collectively “the Agencies”) proposing to reduce regulatory compliance burdens, particularly on community banking organizations, by simplifying certain aspects of the Agencies’ capital rules (the “Proposal”). This letter focuses specifically on the aspects of the Proposal that apply to mortgage servicing assets (“MSAs”).

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Chairman, President and CEO
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We appreciate efforts made to date by the Agencies to work with the financial services industry to understand the implications of the punitive treatment of MSAs under the Basel III rules (the Regulation) which led to issuance of the Proposal. We believe that the Regulation, generally imposed on U.S. financial institutions by an international regulatory body, impedes mortgage lending in the United States, is detrimental to the servicing of mortgages by regulated depository institutions (banks) and should be modified as follows:

- Increase the proposed 25% cap to 50%;
- Reduce the risk-weighting from 250% to 130%.

Let me briefly introduce our company. Founded in 1921 in Seattle, Washington as Continental Mortgage and Loan, HomeStreet Bank has been in the business of originating and servicing mortgage loans on residential and commercial real estate for nearly 100 years. We are now a \$6.8 billion asset diversified community bank operating under a Washington State commercial bank charter in seven Western states and Hawaii. One of our main lines of business is retail origination and servicing of conventional single-family mortgages in both conforming and non-conforming loan amounts, as well as FHA-insured and VA-guaranteed mortgage loans. Total single-family mortgage loan production averages \$8 billion to \$9 billion annually. The majority of these loans are securitized and sold into the secondary market through Fannie Mae, Freddie Mac and Ginnie Mae.

Mortgage loan origination and servicing have been core businesses for HomeStreet for many decades. We have been an approved FHA lender since that program's inception in 1934, and we are Fannie Mae's oldest approved seller-servicer (dating from 1938). HomeStreet is currently the number one originator of purchase mortgages in Washington, Oregon and Idaho. Our credit quality is very sound; total delinquencies were never over 3.0 percent of our serviced portfolio at the depth of the Great Recession, and currently stand at approximately 1.2 percent (including foreclosures). We accomplish this while also providing a significant amount of mortgage financing to low and moderate income groups. In short, we have built our business around outstanding customer service and the prudent extension of mortgage credit to all socio-economic segments in our markets for nearly a century.

At September 30, 2017, our single-family mortgage servicing portfolio totaled approximately 102,700 loans with just over \$24 billion in unpaid principal balances. Our mortgage servicing business is integral to our retail mortgage loan origination and retail deposit businesses. Many of our customers have had numerous mortgages with HomeStreet over a long period of time. Many repeat customers come to HomeStreet for "local" servicing, and their common expectation

is that the servicing of their mortgage loan will not be transferred to a servicer other than HomeStreet.

The punitive treatment of MSAs under Basel III undermines the value of mortgage-servicing assets at all U.S. banks, with adverse impacts on the entire mortgage finance chain. The Regulation, as previously adopted by the Agencies, decreases the value of MSAs that can be included in Common Equity Tier One (CET1) capital from 50 percent to a stringent 10 percent (25 percent under the Proposal), with MSAs above the limit deducted from regulatory capital. Additionally, it increases the risk-weighting of MSAs held by banks from 100 percent to 250 percent. Finally, MSAs, deferred tax assets and equity interests in unconsolidated financial entities are limited, in aggregate, to 15 percent of Tier I capital before they must be deducted from regulatory capital. This unnecessarily punitive treatment of MSAs has transformed them into one of the most capital intensive asset classes in the entire Basel III framework, despite the lack of any linkage between banks with MSAs and the causes of the financial crisis that Basel III was intended to address.

Origination and servicing of mortgage loans is a primary function of banks, and we believe these services provide great value to our customers and communities. It has long been HomeStreet's strategy to originate mortgages and keep the borrowers as customers; we do not like to sell our customers. We sold approximately \$3.0 billion of Fannie Mae servicing in 2014, preparatory to Basel III implementation. We received very negative reaction from many customers whose servicing was transferred to another servicer. We do not want to repeat that experience of alienating and losing a large number of customers.

The Basel III capital rule threatens the business of originating and servicing mortgage loans at HomeStreet, and at many other banks as well. If fully implemented under the original rules, the Regulation would have decreased the Return on Equity of our mortgage servicing business to a level that would have forced us to question the wisdom of continuing to invest capital in that business. Even under the Proposal, the 25 percent cap and 250 percent risk weight could cause us to curtail our mortgage origination and servicing business, or possibly sell another portion of our MSRs to institutions not regulated as banks.

MSA Risk Management

One of the benefits of holding MSAs is that they tend to provide a natural hedge to interest rate and loan production risk, which are among greatest risks that banks face. As interest rates rise and new loan production slows, MSAs increase in value with lower prepayment speeds, thereby mitigating that risk.

The proposed increase in the cap from 10 percent to 25 percent significantly reduces the draconian effect of the original Regulation for many banks, but it is

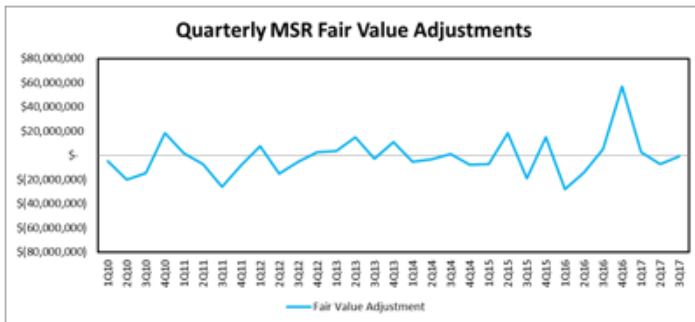
still based on an outdated premise that MSAs are extremely risky and difficult to value. If that were the case years ago, it is not now. MSAs are much better understood and better managed today than they were in the past.

Many institutions, including HomeStreet, engage in various highly effective activities – including hedging – that are very effective in reducing the volatility of the asset. This greater understanding and these practices have greatly reduced the inherent risks of MSAs and have helped banks to value the asset, resulting in a liquid and well-functioning MSA market.

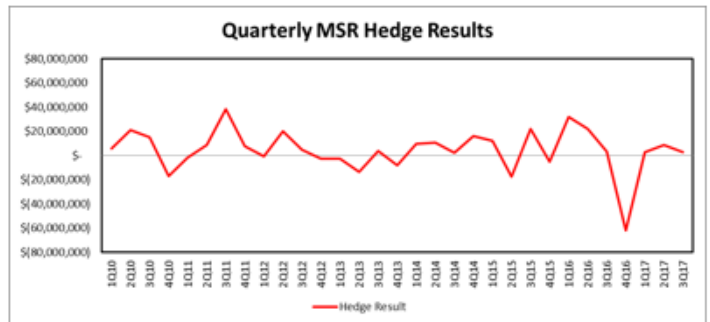
The following chart shows the performance of HomeStreet’s hedge program since first quarter 2010:

Risk Management: Hedging the MSR Fair Value Adjustment

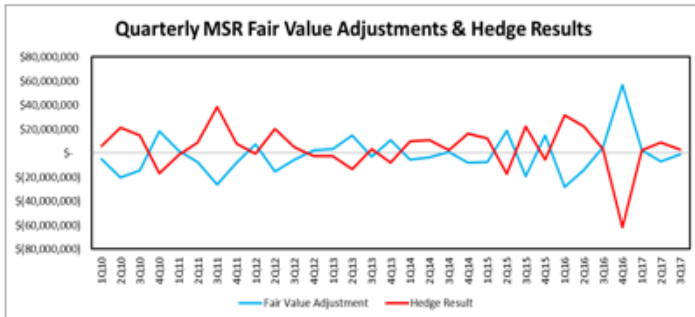
1. The MSR Asset is marked to a valuation model monthly, and changes to the Fair Value are recognized in the P&L



2. MSR Hedge Valuation is also performed monthly, and the corresponding change in valuation is also recognized in the P&L



3. An effective hedging strategy results in a hedge whose value moves in an equal and opposite manner as the MSR Asset



4. Resulting in minimal P&L impact quarterly, and consequently minimal change to the Bank’s Equity / Capital position

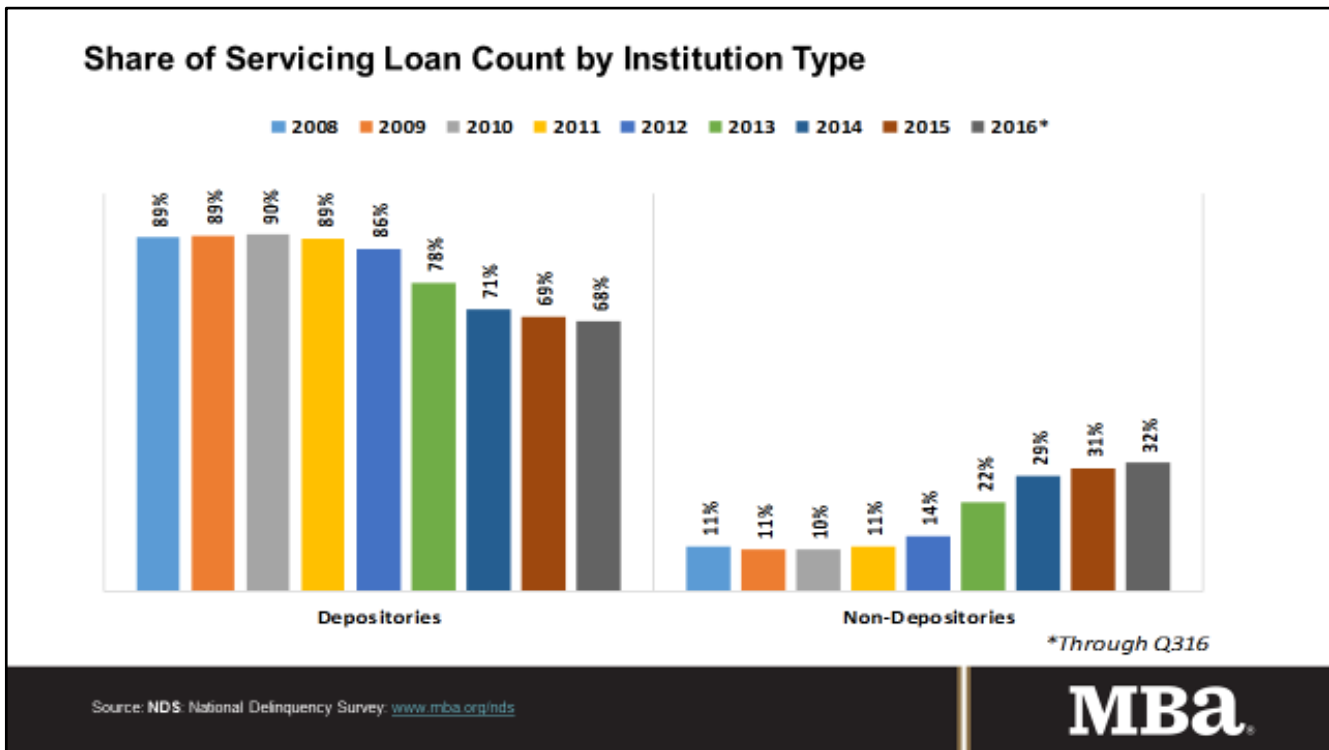


The above slides show the effectiveness of our hedge program over the last eight years. Each month we mark our MSR asset to a valuation model, and a hedge valuation is also performed. Changes to both valuations are recognized in the income statement. As shown on the bottom two slides, the hedge has been remarkably effective in managing the volatility of the asset.

Raise the Cap to 50 Percent

The Basel III rule, even with the proposed modification, adds liquidity risk to holding MSAs by removing a bid from the market. As it becomes increasingly capital intensive to hold MSAs, many banks have reduced their exposure to them by selling servicing to other institutions, often to non-regulated entities, because there are fewer bank purchasers. This is destabilizing to the mortgage servicing system, and potentially harmful to consumers. We have already seen instances of poor to improper servicing of mortgages by non-bank servicers, resulting in harm to consumers. Recent examples of harm to borrowers include inaccurate disclosure of related party services and improper administration of loan impound accounts. All of this is destabilizing to the mortgage system in this country.

The migration of MSAs from regulated to non-regulated institutions in recent years is illustrated in the following chart from the Mortgage Bankers Association. It clearly demonstrates the change in share of MSAs held by depository and non-depository institutions from 2008 through the third quarter of 2016:



Additional data from the MBA through 1Q2017, not shown on the chart, show that MSAs continue to migrate from regulated to non-regulated institutions:

	Q1 2016	Q2 2016	Q3 2016	Q4 2016	Q1 2017
Bank share of servicing for top 50 servicers	66%	65.80%	63.90%	62.20%	60.60%

The migration of MSAs to non-depositories started in 2012 for various reasons, and it gained momentum in 2013 as banks started to prepare for full implementation of the Regulation.

Mortgage servicers must be highly liquid and well capitalized to be able to make required advances during down market cycles. Not only do depositories usually have ready access to capital and liquidity that non-depository companies do not, but depository institutions are subject to oversight by prudential regulators. For these reasons, we believe that the migration of MSAs away from regulated banks to non-regulated institutions poses risks to consumers and is potentially destabilizing to the entire mortgage finance system.

We strongly believe that great performance, balance sheet strength and the quality of customer service should be the drivers by which servicers gain market share, not by the imposition of excessive capital standards on MSAs at depository institutions. We also believe that American banks should not be put at a competitive disadvantage by an international accord that discriminates against an asset that is generally unique and integral to the American mortgage finance system.

In light of the above, we believe it prudent to go back to the pre-Basel era when there was no cap on MSAs that a bank could hold. Mortgage servicing assets are much better understood and managed today, and they provide a safe and sound asset that should not be subject to an arbitrary cap such as that imposed by Basel III. If the Agencies feel strongly that a cap is necessary, we strongly recommend it be raised to 50 percent.

Lower the Risk Weighting to 130 Percent

There is no evidence that banks failed due to exposure to MSAs. In fact, many banks failed due to their unwise and reckless extension of credit, and because of their positions in unsecured commercial or unsecured consumer loans. It is therefore surprising and illogical that unsecured commercial and consumer loans are risk-weighted at 100 percent under Basel III, whereas MSAs are assigned a

minimum risk weight of 250 percent. We strongly recommend that the Agencies amend the risk weighting assigned to MSAs. Not only is there no evidence that MSAs are any riskier than, or even as risky as consumer loans, there is also no evidence that MSAs were a major reason for the 2008-2009 financial crisis.

Current accounting rules that require banks to obtain regular valuations for MSAs have significantly helped to increase the ability of banks to value and price MSAs, which has enhanced the liquidity of the market for MSAs in comparison to that of many types of bank loans that are not subject to the same level of capital requirement. This, coupled with the fact that many banks manage the volatility of MSAs by hedging as demonstrated above by HomeStreet's experience, makes a 250 percent risk weight excessively high for this asset. Moreover, the Proposal assigns a risk weight of 130% for high volatility acquisition, development, or construction loans ("HVADC loans"), which are certainly more risky than MSAs. We believe that it makes no sense for MSAs to be so severely treated compared to the more risky HVADC loans. We strongly recommend that MSAs be assigned a risk weighting that is not more than 130 percent.

The Regulation does not distinguish between prime and subprime loans. It is conceivable that a 250 percent risk weight could be appropriate for MSAs associated with subprime mortgages, as they were major contributors to the financial crisis.

We request that the Agencies give serious consideration to the foregoing discussion, with particular emphasis on the distinction that should be made between MSAs associated with subprime and MSAs associated with prime mortgages. We believe that such consideration would provide support for our position that a blanket 250 percent risk weighting for all MSAs is unduly punitive and unjustified. Therefore, we recommend that the Proposal be amended to assign to MSAs (other than MSAs associated with subprime loans) a risk weight of no more than 130% - the risk weight that is assigned under the proposed HVADC rule.

We greatly appreciate efforts to address concerns raised about the complexity of the capital rules and the punitive treatment of MSAs under Basel III. However, we believe that much still needs to be done in this area. If the Proposal is finalized as is, many banks will be forced to sell servicing, and some will most likely leave the business of originating and servicing mortgages entirely. This would have a negative effect on the availability and cost of mortgages to consumers. We believe that the market for MSAs should encourage and facilitate the transfer of servicing between capable and willing market participants, rather than force transfers that are necessitated by unduly harsh capital rules that impact capable market participants differently. We strongly believe that the changes recommended above

will support the functioning of a liquid market for MSAs, and that they will be good for regulated institutions that service mortgages, and for their customers alike.

The Basel III rules set a punitively high capital requirement that is excessive relative to the risk of mortgage servicing assets. If left unchanged, it will drive good bank servicers out of the business. This will be bad for those banks and bad for consumers. Even if we could live with the increased 25% cap, the 250% risk weighting, which is unduly harsh and illogical, will drive some banks out of this line of business. The result will be the loss of a safe and sound earning asset for these banks.

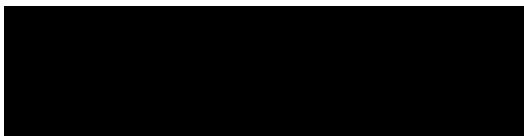
We respectfully request that the cap be increased to 50 percent and the minimum risk weight be reduced to 130 percent.

Conclusion

The Basel III Accord poses a serious threat not only to HomeStreet's mortgage servicing business, but also to the mortgage origination and servicing businesses at all regulated institutions. The Proposal's increase in the cap is a welcome indication of the Agencies' willingness to depart from the letter of the Basel Accord, while staying within the spirit of safe and sound capital treatment. We appreciate that improvement, but we feel that it stops short of what is needed and justified.

On behalf of our Board of Directors and management team, I wish to express my appreciation for your willingness to listen to the industry and to work for a rational solution that will prevent great disruption to many banks and the customers they serve, including HomeStreet Bank. We respectfully request the Agencies rationalize the capital treatment of MSAs relative to much more risky assets by raising the cap to 50 percent and lowering the risk weight to 130 percent.

Very truly yours,



Mark K. Mason
Chairman, President and CEO
HomeStreet Bank