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Via Electronic Delivery

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

RE: Docket ID OCC-2007-0018, Simplifications to the Capital Rules Pursuant to the Economic Growth and Regulatory Paperwork Reduction Act of 1996 (EGRPRA)

To Whom It May Concern:

Flagstar Bank, FSB ("Flagstar Bank") appreciates the opportunity to comment on this notice of proposed rulemaking ("NPR") intended to reduce regulatory burden, especially on community banking organizations, by simplifying compliance with certain aspects of the capital rule. We will focus our comments specifically on the portions of the NPR that address mortgage servicing assets ("MSAs").

Flagstar Bank is the primary operating unit of Flagstar Bancorp, Inc. (combined, "Flagstar") a savings and loan holding company with total assets of approximately $17 billion headquartered in Troy, Michigan. Flagstar conducts community banking primarily in Michigan through its 99 branch footprint and is a leading national originator of residential mortgage loans. Flagstar is a top 5 national bank mortgage originator and top 10 GNMA/FHA/VA lender, providing home loans through a wholesale network of brokers and correspondents in all 50 states as well as 95 retail locations in 26 states. Flagstar is also a leading servicer of mortgage loans, handling payments and record keeping for $91 billion of home loans representing 415 thousand borrowers. Mortgage loan origination and servicing have been important businesses for Flagstar since its founding, and Flagstar has invested heavily to develop core competencies in these areas. Due to the relative size of its mortgage business, Flagstar is disproportionately impacted by the current and proposed regulatory capital treatment of mortgage servicing assets.

Mortgage finance is the foundation of the American consumer financial system. The majority of residential mortgage loans originated are subsequently sold to Fannie Mae, Freddie Mac, or Ginnie Mae, and are serviced by either the entity that extended the loan or a third party. Banks have traditionally performed the role of mortgage lender and servicer. The American homeowner has grown accustomed and comfortable seeking their mortgage financing through the regulated banking system. For many consumers, their mortgage is the largest financial transaction they conduct during their lifetime. Increases in regulation have intensified the complexity of the transaction and borrowers need to be, and deserve to be, guided through the process by an originator and servicer that is interested in a broader, deeper relationship. They trust their bank, and generally have a broader relationship that includes deposit accounts, auto financing, and more. Most consumers appreciate having their loans serviced by the same entity that originated their loan. Banks have become adept at managing the origination and servicing of consumer mortgages, especially given the regulatory oversight they receive, particularly institutions like Flagstar which specialize in these activities. Flagstar Bank has been named a Fannie Mae Servicer Total Achievement and Rewards Performer for two years in a row.

The implementation of Basel III in the United States introduced a framework that is extremely punitive to its bank mortgage lenders by deducting MSAs in excess of 10% of common equity tier one ("CET1") capital from regulatory capital, introducing a 15% combined threshold on the aggregation of MSAs and certain other items, and imposing a 250% risk weighting on MSAs not deducted from capital. This singularly punitive treatment of MSAs made them the most capital intensive asset class in the Basel III framework, despite the lack of linkage between MSAs and the causes of the financial crisis that Basel III was intended to address. The phase-in of deductions of "excess" MSA balances from regulatory capital began in 2015 for non-advanced approaches banking organizations. In November 2017 the banking supervisory agencies issued a final rule staying the phase-in of certain elements of the capital rules, including the MSA deductions from capital, in anticipation of the issuance of this simplifications NPR.

This NPR proposes to raise the 10% MSA threshold to 25% and eliminate the 15% combined threshold, while retaining the 250% risk weighting on MSA not deducted from capital. While this is an appropriate step in the right direction, we do not believe that the NPR goes far enough to mitigate the disruptive impact of the Basel III treatment of MSAs or simplify the unnecessarily complicated capital rules associated with the asset. We believe that consistent risk-based bank supervision and efficient capital rules suggest that there should not be a capital "cliff" deduction applied to MSAs, and the risk weighting should be returned to the pre-Basel III level of 100%.

Inconsistent supervisory treatment of mortgage servicing

The proposed capital treatment of MSAs remains uniquely punitive, even with the cliff threshold raised to 25% of CET1. Other assets deducted from regulatory capital are intangible byproducts of accounting events (goodwill, certain deferred tax assets), not the product of sustained, deliberate, business activities. When a residential mortgage loan is sold to Fannie Mae, Freddie Mac, or Ginnie Mae and the servicing of the loan is retained by the bank that made the loan, the resulting servicing asset is valued at the net present value of expected future cash flows. Because these future cash flows are uncertain, Flagstar values this asset daily using a stochastic valuation model that incorporates all currently available information and marks the value of the asset to its market value. Because the value of the asset is sensitive to financial market conditions and the performance of the loans being serviced, Flagstar also produces a daily rate sensitivity report which is used to manage a hedge portfolio that is designed to offset the change in value of the MSA due to market movements. This hedge portfolio is monitored constantly, rebalanced as frequently as needed, and also valued daily. There are two teams within Flagstar that are completely dedicated to managing the risk inherent in the MSA: one that values the asset and produces a rate sensitivity profile, and another that hedges the value of the asset. Flagstar maintains robust policies, risk limits, procedures, and executive and board oversight with respect to the MSA and its risk management. The MSA value hedge has been very effective day to day and over time in insulating earnings and capital from the impact of changes to the value of the MSA.

Flagstar is aware that few institutions, and maybe not any others our size, practice these same MSA risk management activities. This is exactly why a one-size-fits-all approach to MSA concentrations is inappropriate. As with any risk-taking activity conducted by banks, the appropriateness of concentrations should be assessed relative to the effectiveness of risk management activities. Small concentrations of risky assets may be inappropriate if the risk is not managed, while large concentrations of the same risk may not be a concern if effective risk management systems are in place.

The "Bank Supervision Process" booklet of the Comptroller's Handbook clearly and effectively articulates a risk-based supervisory philosophy, stating in part:

> "The presence of risk is not necessarily reason for supervisory concern. Examiners determine whether the risks a bank assumes are warranted by assessing whether the risks are effectively managed, consistent with safe and sound banking practices. Generally, a risk is effectively managed when it is identified, understood, measured, monitored, and controlled. A bank should have the capacity to readily withstand the financial distress that such a risk, in isolation or in combination with other risks, could cause.
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> If examiners determine that a risk is unwarranted (i.e., not effectively managed or backed by adequate capital to support the activity), they must communicate to management and the board of directors the need to mitigate or eliminate the excessive risk. Appropriate actions may include reducing exposures, increasing capital, and strengthening risk management practices."

Bank examiners have the authority to limit excessive risk taking through direct intervention when thoughtful, targeted assessment of a bank's risk management program identifies imprudent concentrations or practices. Flagstar firmly believes that supervision of MSA risk should be accomplished through the OCC's robust Risk Assessment System, consistent with every other bank risk-taking activity, and not through a cliff threshold above which excess MSAs result in a one-for-one write down of regulatory capital.

Market disruption and disparate impact to mortgage banks

During 2016, Flagstar sold and securitized $32 billion mortgage loans, creating $340 million of MSAs, which amounted to 31% of Flagstar's CET1 at December 31, 2016 despite a CET1 ratio that was more than twice the level to be considered well capitalized. Even with the proposed increase to the MSA threshold Flagstar would generate assets equal to the threshold in less than a year and be forced to sell all newly produced MSA on an ongoing basis so as not to incur large deductions from regulatory capital. While 25% is incrementally better than 10%, any arbitrary cliff threshold on MSA concentrations will result in forced selling of the assets by community banks with relatively larger mortgage lending activities.

This punitive treatment of MSAs incents banks to avoid the asset, driving down the fair value of MSAs. As banks have retreated from the MSA market, non-banks have moved in to take their place. From 2011 to early 2016, the percentage of loans serviced by depository institutions has declined from 89% to 68%, with the number of loans serviced by non-depositories increasing from 11% to 32%. Since Basel III was adopted in the United States in 2013, more than 87% of the $1.87 billion in MSA sales conducted by Flagstar have been to unregulated non-banks. Unless the treatment of MSAs under regulatory capital rules are revised, this trend will continue.

Non depository institutions are not subject to regulatory capital rules, are not as experienced at servicing mortgages, are not subject to prudential regulation, lack the capital and credit-worthiness to enter into appropriately sized derivatives to effectively hedge their MSA positions, and tend to operate with lower levels of liquidity and capitalization. Consumers have experienced difficulty with non-bank servicers regarding the quality of their servicing. We believe that quality of service, risk management practices, and proven performance should be the drivers of mortgage servicing market share, not differences in regulatory treatment.

Non-bank MSA holders have higher return expectations than banks, further driving down the fair value of the servicing asset. The lower fair value for servicing assets adversely impacts bank profit margins, leading to decreased availability and higher mortgage rates for consumers. While the capital deduction for MSA concentrations has been gradually phased in since 2015, it is worth noting that the 250% risk weight is not effective until 2018 and its impact to consumers is not yet known. It is reasonable to assume that banks will demand increased profitability from MSA assets to earn an acceptable return on the increased assigned regulatory capital, which would again result in higher costs for consumers.

Unintended impact of rising interest rates

The existing and proposed capital rules also have the unintended effect of destroying bank capital when MSAs increase in value. If and when MSAs increase in value, Flagstar does not realize the income benefit because the hedge portfolio will decrease in value by a like amount. However, the increasing value of the MSA will cause a larger threshold deduction from capital. The current rules have introduced a new risk of deteriorating capital due to an increasing value for the MSA. This is undesirable, and must have been an unintended consequence.

Risk weighting

There is no documented linkage that we are aware of between MSA concentrations and the most recent financial crisis or bank failures. It is difficult to understand why MSAs would receive a risk weighting of 250% while unsecured commercial loans, unsecured consumer loans, and delinquent residential mortgages receive a risk weighting of 100%. The 250% risk weighting is punitive and not consistent with other risk weightings. We ask that the risk weighting on MSAs be returned to the pre-Basel III level of 100%.

Conclusion

The stated goal of the NPR is to simplify the capital rules to reduce regulatory burden, especially on community banking organizations. We suggest that the most effective way to do this is to remove the unique, punitive treatment of MSAs from the capital rule altogether and instead rely on the OCC's robust risk-based supervisory program to limit inappropriate risk taking by its covered institutions. Doing so would not only simplify the capital rules and align MSA supervision practices with those of other bank activities, but it would restore competition in the mortgage servicing industry, removing the unfair advantage gained by non-banks with the adoption of Basel III in the United States.

Thank you for the opportunity to comment on the proposed rule.

Respectfully,

[redacted]

Alessandro DiNello,
President and Chief Executive Officer