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Noted

April 29, 2011

The Honorable Benjamin S. Bernanke
Chairman
Board of Governors of the
Federal Reserve System
20th Street and Constitution Avenue, NW
Washington, DC 20551

Mr. John Walsh
Acting Comptroller
Office of the Comptroller of the Currency
250 E Street, SW
Washington, DC 20219

The Honorable Sheila C. Bair
Chairman
Federal Deposit Insurance Corporation
550 17th St, NW
Washington, DC 20429

Re: Basel Annex on Mortgage Servicing Rights (MSRs)

Dear Chairman Bair, Chairman Bernanke and Acting Comptroller Walsh:

Mortgage Bankers Association[1] would like to express our continuing concern about a potential change in the rules related to the regulatory capital treatment of mortgage servicing rights (MSRs). As you know, on July 26, 2010, the oversight body of the Basel Committee on Banking Supervision (Basel Committee) approved an annex to the Basel accord which directs member country bank regulators to adopt rules for the treatment of specific assets in determining Tier I capital for regulatory capital reporting purposes. Under the annex (Basel Annex), the following assets may receive only limited recognition when calculating the common equity component of Tier I capital, with recognition for each class of assets individually capped at 10 percent of the common equity component of Tier I capital:

[1] The Mortgage Bankers Association (MBA) is the national association representing the real estate finance industry, an industry that employs more than 280,000 people in virtually every community in the country. Headquartered in Washington, D.C., the association works to ensure the continued strength of the nation's residential and commercial real estate markets; to expand homeownership and extend access to affordable housing to all Americans. MBA promotes fair and ethical lending practices and fosters professional excellence among real estate finance employees through a wide range of educational programs and a variety of publications. Its membership of more than 2,200 companies includes all elements of real estate finance: mortgage companies, mortgage brokers, commercial banks, thrifts, Wall Street conduits, life insurance companies and others in the mortgage lending field. For additional information, visit MBA's Web site: www.mortgagebankers.org.

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- Significant investments in the common shares of unconsolidated financial institutions,
- Mortgage servicing rights, and
- Deferred tax assets that arise from timing differences.

In addition, under the Basel Annex a bank must deduct the amount by which the aggregate of the three items above exceeds 15 percent of its common equity component of Tier I capital.

This treatment would be a significant change to the treatment under existing U. S. regulatory capital rules. As expressed in MBA's letter to you on October 21, 2010, MBA believes that this rule, if adopted by prudential bank regulators in the United States, would be deleterious to banks holding MSRs.

As stated in MBA's October 21, 2010 letter, MBA believes that further restrictions on bank investments in MSRs makes little sense for the following reasons:

- Unlike equity interests in unconsolidated financial institutions and deferred tax assets, servicing rights have contractual cash flows that are relatively stable and easy to project.
- Unlike equity interests in unconsolidated financial institutions and deferred tax assets, servicing rights are readily marketable.
- MSRs are already treated as 100 percent risk-weighted assets.
- There are existing limitations on MSRs before they must be deducted from Tier I capital.
- The largest single risk in holding residential MSRs relates to prepayment risk; banks have demonstrated the ability to hedge most of this risk.
- Commercial MSRs generally have little prepayment risk.
- MSRs are a source of predictable deposits for banks and are a mechanism to develop a long-term customer relationship.

MBA cites the following impacts of the Basel Annex, if adopted in the United States:

- Banks would exit or significantly restrict additional involvement in servicing activities and many would have to sell all or a portion of their existing MSRs;
- The increase in cost of capital would, possibly, be passed on to consumers;
- Banks' exit of servicing activities would result in the loss of one of the principal relationships between banks and their customers;
- Servicing activities would migrate to less regulated entities; and
- MSRs would suffer a loss in value due to the additional capital required to support some MSRs as well as the reduction in benefit from escrow float.

MBA recommends that the Basel Annex not be adopted by U.S. bank regulators. If, however, U.S. bank regulators move forward with the proposed treatment, MBA recommends that its impact be reduced in order to ensure that the mortgage market is

not adversely impacted. As suggested in MBA's October 21, 2010 letter, this could be done in a number of ways including:

- The MSR cap before deduction from the common equity component could be raised to a higher level.
- MSRs could be excluded from the 15 percent cap.
- MSRs existing as of the date of enactment could be "grand-fathered" and not subject to the limitations under the Basel Annex.
- Measurement of residential MSRs for purposes of the 10 percent and 15 percent limits in the Basel Annex could be limited to the unhedged value of the MSRs.
- Servicing of commercial MBS could be carved out completely from the application of the Basel Annex because of the absence of prepayment risk.

The following are two additional ideas that MBA requests the FED, OCC, and FDIC consider in any proposed rule related to the Basel Annex.

Deferred Tax Offset

Many servicers have deferred tax liabilities recorded on their books related to a tax safe harbor that applies when a taxpayer originates mortgages, and sells them while retaining servicing rights. In 1991, the Internal Revenue Service issued Revenue Ruling 91-46 which provides that to the extent that the servicing contract entitles the taxpayer to receive amounts that exceed "reasonable compensation" for services to be performed (often called "excess servicing rights"), these amounts must be treated under the tax rules that deal with "stripped coupon" bonds. The procedures for implementing the Revenue Ruling were spelled out in Revenue Procedures 91-49, 91-50, and 91-51. A "MSR Safe Harbor" for servicing one-to-four unit residential mortgages was provided to determine the amount that was attributable to "reasonable compensation", which is often called "normal servicing rights." Under the MSR Safe Harbor, reasonable compensation is the sum of "float income", certain late fees and escrow fees, plus a certain percentage of the outstanding principal to be serviced using the following annual safe harbor rates: (1) for conventional, fixed rate mortgages, 0.25 percent; (2) for a mortgage that is less than one year old that is insured by the Federal Housing Administration, Veterans Administration, or Farmers Home Administration, 0.44 percent; and (3) for any other one-to-four unit residential mortgage, 0.375 percent. If the original principal balance is $50,000 or less, the safe harbor rate for servicing that mortgage is 0.44 percent. Thus, the part of the mortgage interest related to "normal servicing rights" is treated as compensation for future services, and that portion is not currently taxable. To the extent the servicing rights exceed the MSR Tax Safe Harbor amounts (the "excess servicing rights") they are treated under the "stripped coupon" tax rules.

If an MSR is impaired or de-recognized in a servicer's balance sheet, the liability for tax on future income is extinguished. The result of this treatment is the maximum exposure to loss is the MSR asset, net of the related deferred tax liability. Accordingly, MBA

believes that in calculating the 10 percent and 15 percent limits under the Basel Annex, the net of MSRs and related deferred tax liabilities should be used.

Existing bank regulation allows for a deferred tax liability offset to MSRs in Title 12, Appendix A to Part 225, Section II.B.1.E.iii which states: "Bank holding companies may elect to deduct goodwill, disallowed mortgage servicing assets, and disallowed credit-enhancing I/Os on a basis that is net of any associated deferred tax liability. Deferred tax liabilities netted in this manner cannot also be netted against deferred tax assets when determining the amount of deferred tax assets that are dependent on future taxable income."

If the Fed, OCC and FDIC decide to move forward and propose a rule similar to the Basel Annex, MBA again requests that the recommendations from MBA's October 21 letter, summarized above, for reducing the impact of the Basel Annex be incorporated in the final rule.

In addition, the Basel Annex did not specifically mention a deferred tax liability offset against MSRs or against deferred tax assets. MBA, therefore, wants to confirm its expectation that the deferred tax liability offset may continue to be used to offset the MSR asset or to offset deferred tax assets in the calculation of the proposed Tier I deductions.

<u>**Reserves Offset**</u>

In servicing loans for Fannie Mae and Freddie Mac, the seller representations and warranties attach to the servicing rights. The Fannie Mae guide states:

> When Fannie Mae consents to a transfer of servicing by a lender, it relies on the integration and non-divisibility of the Contract. Fannie Mae requires that the transferor or lender remain obligated for all selling representations and warranties and recourse obligations upon the transfer of servicing, and requires that the transferee servicer, whether the original seller or a transferee servicer, undertake and assume joint and several liability for all selling representations and warranties and recourse obligations related to the loans it services unless explicitly agreed to the contrary in writing by Fannie Mae. [2]

The seller of a loan must record a liability for seller representations and warranties. Since Fannie Mae and Freddie Mac make the servicer undertake a joint and several liability for seller representations and warranties, the liability recorded for Fannie Mae and Freddie Mac reps and warranties could be deemed to relate to the MSR. MBA, therefore, recommends that in drafting any rules related to the Basel Annex, the bank regulators should allow for a reserve offset in situations where the seller warranties attach to the MSR asset.

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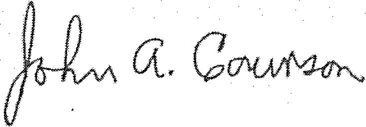
[2] Selling Guide, Fannie Mae, Part A, Subpart 2, Chapter 1.

MBA would like to open up a dialogue with the FDIC, the OCC and the Fed about the Basel Annex and its applicability to risk-based capital requirements in the United States. The MBA appreciates the opportunity to share these comments, observations and recommendations with you. Any questions about this letter should be directed to Jim Gross, Vice President and Staff Representative to MBA's Financial Management Committee, at (202) 557-2860 or jgross@mortgagebankers.org.

Yours truly,



John A. Courson
President and Chief Executive Officer