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VIA ELECTRONIC DELIVERY

Office of the Comptroller of the Currency
250 E Street S.W.
Mail Stop 2–3
Washington, D.C. 20219
OCC Docket ID OCC-2012-0008
OCC Docket ID OCC-2012-0009

Jennifer J. Johnson
Secretary
Board of Governors of the Federal Reserve System
20th Street and Constitution Avenue N.W.
Washington, D.C. 20551
Docket No. R–1430; RIN No. 7100–AD87
Docket No. R–1442; RIN No. 7100 AD87

Robert E. Feldman
Executive Secretary
Attention: Comments/Legal ESS
Federal Deposit Insurance Corporation
550 17th Street N.W.
Washington, D.C. 20429
FDIC, RIN 3064–AD95
FDIC, RIN 3064–AD96

RE: Treatment of Mortgage Servicing Assets in Proposed Regulatory Capital Rules: Regulatory Capital, Implementation of Basel III, Minimum Regulatory Capital Ratios, Capital Adequacy, Transition Provisions, and Prompt Corrective Action[1] and Standardized Approach for Risk-Weighted Assets, Market Discipline and Disclosure Requirements[2]

Ladies and Gentlemen:

The law firm of Covington & Burling LLP, on behalf of a savings and loan association client, appreciates the opportunity to comment on the two notices of proposed rulemaking referenced above as they related to mortgage servicing assets ("MSAs"). The

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[1] Basel III Numerator NPR, 77 Fed. Reg. 52,792 (Aug. 30, 2012).

[2] Standardized Approach NPR, 77 Fed. Reg. 52,888 (Aug. 30, 2012).

proposed treatment of MSAs substantially changes the existing risk-based capital framework. We, on behalf of our client, respectfully offer that the proposed changes are unwarranted because they do not recognize the differences between MSAs in the United States and other intangible assets. We therefore urge the Agencies to maintain the existing capital treatment of MSAs.

Alternatively, if the Agencies implement the proposed changes, we recommend that any rule adopt the changes described in this letter to better align the risk of MSAs with regulatory capital and to reduce competitive inequality between U.S. and international banking organizations.

I. Proposed Treatment of Mortgage Servicing Rights

The proposed rules would dramatically change the existing treatment of MSAs. The existing risk-based capital rules limit MSAs to 100 percent of tier 1 capital and impose a 10 percent haircut on the fair market value of MSAs as set forth in section 475 of the Federal Deposit Insurance Corporation Improvement Act ("FDICIA") of 1991.[3] We, on behalf of our client, believe that these existing regulatory capital requirements for MSAs appropriately reflect the risk of MSAs in the U.S. market.

The proposed rules, by contrast, would further limit recognition of MSAs. Generally, the Basel III Numerator NPR would reduce to 10 percent of common equity tier 1 capital ("CET1") the amount of MSAs that banking organizations are allowed to recognize.[4] The NPR would also limit the combined balance of MSAs, significant investments in the common stock of unconsolidated financial institutions, and deferred tax assets to 15 percent of CET1.[5] Along with the proposed 10 and 15 percent thresholds, MSAs would continue to be subject to the existing 10 percent FDICIA haircut.[6] In addition, MSAs that are not deducted from CET1 would receive a 250 percent risk weight.[7] The simultaneous application of all three restrictions—the 10 and 15 percent CET1 thresholds, existing 10 percent FDICIA haircut, and 250 percent risk-weight for MSAs not deducted from CET1—would impose unnecessarily punitive capital requirements on MSAs.

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[3] 12 U.S.C. § 1828 note.

[4] *See* Basel III Numerator NPR, 77 Fed. Reg. 52,863, § __.22(d).

[5] *See id.*

[6] *See id.* at 52,823 & n. 84.

[7] Standardized Approach NPR, 77 Fed. Reg. 52,951, § __.32(l)(4).

The Standardized Approach NPR would impose additional restrictions on servicer cash advances for securitization exposures. Servicing banks often provide a credit facility to securitizations, such as MSAs, to "advance cash to ensure an uninterrupted flow of payments to investors in the securitization."[8] Any servicing advance that does not meet the requirements of an "eligible servicer cash advance facility" could be risk-weighted at up to 1,250 percent.[9] The 1,250 percent risk weight would have the effect of deducting the entire advance directly from capital (if not more).

The simultaneous application of all of these restrictions would impose an unreasonably demanding capital requirement on MSAs. In fact, the proposed 250 percent risk weight on MSAs would, by itself, be more burdensome for banks. For example, assume that a banking organization must have an 8 percent total capital to total risk-weighted assets ratio to be adequately capitalized. The existing framework requires institutions to hold capital equivalent to 17.2 percent of the MSAs (10 percent required under the FDICIA haircut plus 8 percent of the remaining 90 percent of MSA value). Under the Basel III Numerator NPR, the minimum capital requirement associated with MSAs would be 28 percent (the 10 percent FDICIA haircut plus 8 percent times the 250 percent risk weight on 90 percent of MSA value). Therefore, Basel III Numerator NPR would require a 62 percent increase over the existing capital requirement.

Importantly, this example does not include any risk weighting for servicer advances and does not include any additional adjustment for MSAs in excess of the 10 percent limit or the combined 15 percent limit.[10] If any amount of the bank's MSAs were subject to these additional proposed deductions, the capital impairment associated with MSAs would be even more severe.

We, on behalf of our client, believe that these proposed changes are excessive and unwarranted for the reasons set forth below.

II. Proposed Rules Are Inappropriate for MSAs in the U.S.

We appreciate the Agencies' efforts to support the safety and soundness of the banking system by revising the risk-based capital framework. However, on our client's behalf, we believe that the proposed treatment of MSAs is inappropriate and unnecessary given:

- The quantifiable value of MSAs in the U.S.;

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[8] *Id.* at 52,918.

[9] *Id.*

[10] *See* Basel III Numerator NPR, 77 Fed. Reg. 52,863, § __.22(d).

- The importance of MSAs to savings and loan associations;
- The negative impact of the proposed rules on borrowers;
- The potential shift of mortgage servicing to the non-banking sector; and
- The disproportionate impact of the proposed rules on U.S. banking organizations compared with international organizations.

A. MSAs Are Distinct from Other Intangible Assets

The proposed MSA rules appear to improperly equate MSAs with other intangible assets such as deferred tax assets and investments in unconsolidated financial institutions. This comparison is inaccurate and does not reflect the contrast between the quantifiable value of MSAs and the theoretical value typically associated with intangible assets. Intangible assets have value only to one organization, have indeterminate duration, tend to have large fluctuations in value, and have a high degree of uncertainty regarding the future benefit of the asset. The structure and risk profile of MSAs bear no resemblance to intangible assets such as equity interests in the common shares of unconsolidated financial institutions or deferred tax assets for the following reasons:

- MSAs are marketable, liquid, and easily valued through a robust secondary market;
- MSAs have contractual cash flows that maintain their value independent of the financial condition of the owner; and
- Risks associated with MSAs can be managed with hedges and other contractual provisions.

1. MSAs are Marketable and Liquid

Intangible assets generally are not liquid or efficiently marketable. MSAs, by contrast, are liquid and readily marketable assets that can be easily valued. The U.S. has developed a robust secondary market for the acquisition and disposition of MSAs: specialty brokers connect buyers and sellers, and market participants follow standardized information tapes and due diligence procedures. In addition, a number of firms specialize in independent MSA valuation services. Banks that must include MSAs in their stress tests have developed particularly sophisticated MSA valuation models. Thus, unlike most intangible assets, MSAs have a quantifiable market value and are readily marketable.

2. MSA Values Depend on Predictable, Contractual Cash Flows

Intangible assets typically do not have contractual cash flows. As a result, the value of the asset may depend on the financial condition of the owner of the asset. This is not true of MSAs. Unlike typical intangible assets, MSAs have contractual cash flows through servicing fees, late fees, incentives for loss mitigation, float income on escrow deposits, and other charges. These cash flows are predictable and can be projected over a specified period of time. The value of MSAs accordingly depends on these predictable, contractual cash flows rather than the financial condition of the owner of the MSA. Thus, unlike typical intangible assets, MSAs are readily marketable and valuable even when the banking organization holding them is in distress.

3. Risks Associated with MSAs Can Be Effectively Managed

MSAs performed reasonably well through the recent crisis, despite the increase in defaulted mortgages, because the risks associated with MSAs were effectively managed. The biggest risks in residential MSAs are: (i) prepayment risk, and (ii) the risk of higher costs related to servicing delinquent loans. Prepayment risk is hedged effectively through the use of various derivative instruments. The MSA valuation process includes scenarios with higher costs related to servicing delinquent loans. In addition, increases in servicing costs due to higher default rates are partially off-set by additional cash flows from loss mitigation incentive programs provided by the Federal Housing Administration (“FHA”), Department of Veterans Affairs (“VA”), Rural Housing Service (“RHS”), Fannie Mae, Freddie Mac, and the U.S. Treasury. Many private label securities also offer additional monetary incentives for loss mitigation efforts and delinquent loan servicing. Thus, although overall costs may increase when the level of defaulted loans is higher than expected, much of this increase is off-set by additional contractual cash flows.

Moreover, the risks associated with MSAs are not closely correlated with foreclosures. For example, the loan insurer or guarantor, namely FHA, VA, and RHS, assumes the bulk of the credit loss related to Ginnie Mae servicing. Both the servicer and investor are made whole via an insurance claim to the government insurer or guarantor. Similarly, Fannie Mae and Freddie Mac bear the credit exposure for agency loan servicing. Credit losses on private securitization MSAs are assumed by the investors in the underlying private label securities and not the servicer. Mortgage insurance on GSE and private servicing further reduces credit loss exposure to both servicers and investors. These features further reduce the risk of MSAs.

B. Role of Savings and Loan Companies

The proposed treatment of MSAs overlooks the significant role state and federally chartered thrifts play in the residential mortgage origination and servicing markets. In fact, the primary public policy behind savings and loan associations is to encourage home lending and home ownership.[11] These institutions' primary strategy is to match deposits with local consumers' residential mortgage loan needs, including mortgage servicing. Thrifts are also active in the mortgage backed securities ("MBS") marketplace for loans held in portfolio or securitized after origination. The proposed rules create a disincentive for banking institutions to service mortgages and to hold MSAs, which undermines the very purpose of the thrift charter.

C. Impact on Borrowers

The proposed mortgage servicing rules would drastically change the landscape for banking organizations that service loans and invest in MSAs, encouraging many to adjust their business models to avoid the negative capital consequences associated with MSAs. For example, the rules would provide an incentive for lender banks to sell off their servicing rights, thus breaking up the bank-borrower relationship. Banks that keep servicing rights would increase fees charged to borrowers in order to compensate for the higher capital charge under the proposed rules. Banks also might exit the mortgage servicing industry to achieve similar returns with fewer capital costs in other asset classes. These actions would limit ongoing relationships between banks and mortgage borrowers, increase fee expenses to borrowers, and, as described further in the next section, drive servicing to the non-bank sector.

D. Shift of Mortgage Servicing to Non-Depository Institutions

As banking organizations reduce their exposure to mortgage lending and MSAs, mortgage servicing will migrate to less regulated non-depository institutions that are not subject to the proposed capital charges on MSAs. As a result, consumers will not receive the benefits imparted by the Agencies' specific examination procedures for servicing assets and operations. Borrowers also might experience higher costs for similar services because non-banks typically require higher rates of return on investments. Moreover, non-depositories operate with higher funding costs and less liquidity than banks, so their ability to meet MSA investor obligations is less certain.

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[11] *See, e.g.*, 12 U.S.C. § 1464(a).

E. Disparate Impact on U.S. Banking Organizations

The international Basel III rules, which have similar MSA limitations, have a minimal impact on international banking organizations because international MBS markets are far less organized and less sophisticated than U.S. MBS markets, of which MSAs are a component. International banking organizations also typically originate mortgages for their own portfolio rather than sell and securitize the mortgages. By contrast, the proposed rules would have a disproportionately larger impact on U.S. banking organizations, which often sell mortgages, retain servicing rights, and are active participants in the well-organized and sophisticated MBS markets, which includes MSAs. The proposed MSA rules therefore would have a disparate impact on U.S. banking organizations. Thus, while the international Basel Framework intends to level the playing field among international institutions, the one-size-fits-all approach for MSAs would have the opposite effect.

III. Recommended Changes to the Proposed Treatment of MSAs

Any capital rules for MSAs should reflect the unique structure and strength of the U.S. mortgage and servicing market and set appropriate limits based on the specific risk characteristics of MSAs, and not based on the characteristics of other intangible assets. The existing regulatory capital treatment of MSAs is appropriate in light of the unique characteristics of MSAs in the U.S. Thus, on behalf of our client, we recommend that the proposed MSA rules not be adopted in the United States for all of the reasons stated above.

However, if the Agencies move forward with implementing the proposed MSA rules, we, on behalf of our client, strongly believe that the following non-mutually exclusive changes would better align the risk of MSAs with their capital treatment, ensure minimal impact to consumers, and minimize disparities between U.S. and international banking organizations:

- Establish the MSA threshold at 50 percent of CET1 for savings and loan associations;
- Eliminate the existing 10 percent FDICIA haircut, which would be redundant and punitive;
- Recognize mortgage insurance, which increases the value and decreases risk of loss on MSAs;
- Recognize existing reserves associated with MSAs, which serve a similar purpose as regulatory capital; and
- Grandfather existing MSAs.

A. Set MSA Threshold at 50 Percent of CET1

We strongly recommend that any rule establish the MSA threshold at 50 percent rather than 10 percent of CET1.[12] This represents a 50 percent reduction from the current 100 percent threshold of tier 1 capital. We believe that this 50 percent threshold is more appropriate due to the inherent value of MSAs and sophisticated market for MSAs in the U.S. This threshold also would reduce the negative capital impact of the proposed rules on U.S. banking organizations, helping to level the playing field between U.S. and international banking organizations.

B. Eliminate Existing 10 Percent FDICIA Haircut

We strongly recommend that any rule reduce the existing 10 percent FDICIA haircut to 0 percent, as permitted under the statute.[13] Rather than apply the proposed MSA restrictions without consideration for existing limits, regulators must recognize that the simultaneous imposition of all of these restrictions is regulatory overkill. In the example provided above, for example, the 250 percent risk weight on MSAs not deducted from capital would represent a 62 percent increase over existing capital requirements. This burden would be even higher with the proposed 10 and 15 percent thresholds and the 10 percent FDICIA haircut.

C. Recognize Mortgage Insurance

MSAs related to mortgage loans that are subject to private or government mortgage insurance should not be deducted from CET1 and should receive a lower risk weight. Mortgage insurance, particularly if the insurance is provided by an agent of the U.S. government, significantly enhances the value of MSAs by guaranteeing cash flow on the asset. Likewise, mortgage insurance reduces losses on MSAs by guaranteeing part or all of the income.

D. Recognize Existing Reserves

To the extent a banking organization maintains reserves against MSAs, these reserve amounts should be recognized and allowed to offset any capital deduction requirements under the proposal. Like regulatory capital, banking organizations hold reserves to withstand potential losses on assets. Capital already set aside to account for risk associated with MSAs therefore should be included in a bank's capital calculation. Otherwise, banking organizations

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[12] MSAs should be removed from the cumulative 15 percent threshold for deferred tax assets and significant investments in the common stock of unconsolidated financial institutions. As described above, MSAs are substantially different from these types of intangible assets.

[13] *See* 12 U.S.C. § 1828 note; Basel III Numerator NPR, 77 Fed. Reg. 52,823 & n. 84.

would be required to hold double the capital for potential losses—once in existing reserves and once as part of the proposed capital requirements.

E. Grandfather Existing MSAs

As described above, the proposed capital rules are significantly more onerous than the existing capital requirements. U.S. depositories actively participating in the MBS marketplace should not be forced unnecessarily to liquidate assets on the balance sheet in response to the proposed capital rules. To minimize disruptions to the mortgage market, and to enforce basic principles of fairness, any final rule should apply only prospectively. MSAs existing as of the date a final rule is implemented should be grandfathered under the existing 100 percent threshold.

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We appreciate the opportunity, on our client's behalf, to provide comments on the Basel III Numerator NPR and the Standardized Approach NPR as they relate to MSAs. On behalf of our clients, we strongly urge the Agencies to maintain the existing capital framework for MSAs. These existing rules appropriately recognize the liquidity, value, cash flows, and risks associated with MSAs. The proposed MSA rules, by contrast, would have significant unintended consequences such as increasing mortgage rates, tightening mortgage credit conditions, shifting mortgage servicing from banks to non-banks, and slowing the economy. Alternatively, any changes to the existing capital requirements for MSAs should adopt the recommended changes described above to better align capital rules with the risk of MSAs in the U.S. and to reduce the potential for unintended negative effects on mortgage markets.

Sincerely,

Keith A. Noreika