November 12, 2014

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Re: Market and Consumer Impact of the Treatment of Mortgage Servicing assets under Basel III

Dear Madam and Sirs:

The undersigned trade associations represent companies engaged in real estate finance and servicing. The following comments relate to significant concerns we have with respect to the treatment of mortgage servicing assets (MSAs) under Basel III. Basel III is having a significant negative impact on the real estate finance markets by unnecessarily disrupting and distorting key business activities. If left unchanged, it has the potential to seriously affect the availability and cost of mortgages to consumers. We believe that the market for MSAs should allow servicing to be transferred between capable and willing market participants. The distortions are being created by Basel III's unduly harsh treatment of MSAs and need to be addressed by the banking agencies.

There are many business models and charters under which mortgage servicing activities are conducted. The overarching issue is that those companies that want to service, and do it well, should not be discouraged from servicing by excessive capital standards or other onerous regulations. There are excellent servicers in both the bank and non-bank space. Servicing is a line of business, and financial services companies can invest their money in other lines of business or in a variety of financial assets if capital requirements on servicing assets are set too high or if other rules are so onerous that they expose companies to excessive risk. Basel III is just such a rule. It sets a punitively high capital requirement that is excessive relative to the risk of the asset. It will drive good bank servicers who want to service out of the business. This is bad for those banks, bad for investors, and bad for consumers. Performance, capacity and service should be the primary drivers of who gets market share in servicing not excessively high capital standards on one segment of the industry.

Our Joint Recommendations

The undersigned trade associations believe the Basel III limits on MSAs should not be adopted in the U.S. MSA capital treatment should continue under the current capital framework without imposing a 10 percent cap or a 250 percent risk-weighting under Basel III. As discussed below, regulators have failed to present compelling evidence that current concentrations of MSAs on bank balance sheets pose a threat to safety and soundness. Additionally, MSAs as a meaningful contributor to the financial crisis of 2008-09 has yet to be identified. In today's ultra low interest rate environment, forcing banks to sell MSAs actually introduces new interest rate risks that must be measured and mitigated. If, however, U.S. bank regulators move forward with the Basel III treatment, we recommend that its impact be reduced in order to ensure that the mortgage market is not adversely impacted. Specifically, we recommend that changes be made to:

Change the Risk-Weighting Back to 100 Percent
We could not identify any bank that failed because of its position in MSAs. In contrast, many banks have failed because of their positions in unsecured commercial loans and unsecured consumer loans which are risk-weighted 100 percent under Basel III. We recommend that U.S. regulators change the risk-weighting to 100 percent for MSAs not directly deducted from capital.

Increase the 10 Percent Cap
The MSA cap before deduction from the common equity component should be raised to a higher level so that banks can continue to service their retail customer base.

Exclude MSAs from 15 Percent Cap
MSAs should be excluded from the 15 percent cap. MSAs are more liquid than deferred tax assets and equity interests in unconsolidated subsidiaries. As noted above, MSAs have contractual cash flows that are at the top of the cash flow waterfall of securities.

Background

In several of our individual trade association comment letters to you, we indicated that the proposed treatment of MSAs under Basel III would likely result in a major market disruption as servicing is permanently shifted from both large and small depository institutions that specialize in mortgage banking to non-depository institutions and banks with lower levels of MSAs.

The following charts depict the extent of change in the top ten single-family residential servicers during the six year period ended December 31, 2013.[1] The companies highlighted in yellow are non-depository servicers.

[1] Laurie Goodman and Pamela Lee, Urban Institute, *Oasis: A Securitization Born from MSA Transfers*, c. March 2014, page 2 and 3. Their stated source is *Inside Mortgage Finance.*

Table 1: Top 10 Mortgage Servicers by Market Share

Rank	2008		2009		2010		2011		2012		2013	
1	Bank of America	19%	Bank of America	20%	Bank of America	20%	Wells Fargo	18%	Wells Fargo	19%	Wells Fargo	19%
2	Wells Fargo	16%	Wells Fargo	17%	Wells Fargo	17%	Bank of America	17%	Bank of America	13%	Chase	10%
3	Chase	14%	Chase	12%	Chase	12%	Chase	11%	Chase	11%	Bank of America	8%
4	Citi	7%	Citi	6%	Citi	6%	Citi	5%	Citi	4%	Ocwen	5%
5	Residential Capital	3%	GMAC	3%	Ally	3%	Ally	4%	US Bank	3%	Nationstar	4%
6	National City	2%	SunTrust	2%	US Bank	2%	US Bank	2%	Nationstar	2%	Citi	4%
7	IndyMac	2%	US Bank	2%	PHH Mortgage	2%	PHH Mortgage	2%	PHH Mortgage	2%	US Bank	3%
8	SunTrust	1%	OneWest Bank	2%	SunTrust	2%	SunTrust	2%	Residential Capital	2%	PHH Mortgage	2%
9	PHH Mortgage	1%	PNC Mortgage	1%	OneWest Bank	1%	PNC Mortgage	1%	SunTrust	1%	Walter	2%
10	HSBC North America	1%	PHH Mortgage	1%	PNC Mortgage	1%	OneWest Bank	1%	PNC Mortgage	1%	Quicken Loans	1%

Below is a summary of the bank vs. nonbank trend:

Table 2: Share of Servicing Market Held by Top 10 Servicers

Top 10 Servicers	2008	2009	2010	2011	2012	2013
Bank Share	65%	66%	64%	61%	54%	44%
Nonbank Share	1%	1%	2%	2%	4%	15%

Banks of all sizes are having problems with the new limits. One dramatic example of the shift from depositories to non-depositories is new Ginnie Mae MBS issuance. In 2010, 82.3 percent of issuance volume was from depository institutions. In contrast, through October 2014, only 50.5 percent of Ginnie Mae issuance volume was from depositories.[2]

We continue to believe that the treatment of MSAs in the final Basel III rule is overly harsh and does not reflect the actual risks of owning MSA assets. The intent of this letter is to point out that an irrational risk-based capital rule is causing depositories to exit or reduce their positions in a safe and sound asset.

The Case for Bank Ownership of MSAs

A Primary Retail Customer Relationship

We point out that two of the principal relationships that banks have with their retail customers are the deposit relationship and the mortgage relationship. Banks believe that there is synergy in having customers with multiple relationships in terms of customer retention and ability to

[2] Ginnie Mae, *Ginnie Mae Overview,* November 2014, slide 12.

cross-sell fee for services relationships to improve bank profitability. Once a bank sells the servicing related to the mortgage relationship, the synergy with the customer is significantly reduced.

Part of the synergy relates to the deposits a bank receives from servicing a customer's loan. As a bank receives monthly payments of principal and interest, it generally has those payments on deposit for several weeks until the monthly remittance date to the investor in the loan. Likewise, most borrowers include in their monthly payment one-twelfth of the annual real estate taxes and annual hazard insurance bill so they have sufficient funds for paying these costs. Such escrow funds on deposit at the bank generally average between $1,000 and $2,000 making servicing a dependable and stable source of deposits for banks from their retail customers.

Customers appreciate having their primary banking relationships with one bank so they can access their account information on one website, make mortgage payments at the local branch, and contact branch employees on routine questions such as questions regarding their year-end tax statement or annual escrow analysis. Federal disclosure requirements contemplate that some customers may seek out those lenders that retain their mortgage servicing for just these reasons.

A Primary Source of Gain on Sale of Mortgages

When a loan is sold or securitized with the MSA retained by the bank, the gain on sale consists of the cash received on the sale of the loan plus the MSA capitalized, less the basis in the loan. The capitalization of the MSA is a large portion of the gain on sale.

In order for banks to reduce the potential adverse capital impact of owning MSAs, banks may be compelled to sell the loans servicing released or to arrange for monthly or quarterly sales of the MSAs if they elect sales or securitizations of loans, servicing retained. This usually will not be the "best execution" for the bank in most markets. These losses in profitability and MSA value will likely be passed on to consumers in the form of higher interest rates on mortgages.

Loss of a Safe and Sound Earning Asset

MSAs provide a reliable source of revenue to banks from:

- Servicing fees collected monthly by the servicer out of borrower payments. The servicing fees are taken out of the interest cash flows as a percent of principal. Assuming an average principal balance of $200,000, the fees would range from $500 to $880 per annum. **Contractual servicing fees are paid at the top of the cash flow waterfall for Ginnie Mae MBS and most private label single-family servicing. Servicing fees on Fannie Mae and Freddie Mac MBS are contractual obligations of and are paid directly to the servicer by Fannie Mae and Freddie Mac.**
- Earnings on escrow deposits of principal and interest and borrower taxes and insurance provide an inexpensive source of deposits to banks.
- Other ancillary income belongs to the servicer.

These sources of earnings are contractual cash flows that are defined in the seller/servicer guides of the investors. The contractual cash flows have caused a market to be made around the sale of MSAs, and many banks carry MSAs at fair value on their balance sheet. This market includes a half dozen or more brokers who specialize in MSA sales, and the market for MSAs has been around for over 30 years.

Loss of Natural Hedge to the Loan Production Side of the Business
When long-term interest rates are low, nationwide production volumes increase. Gain on sale margins also tend to be highest when volumes are high, as loans in pipeline approach banks' production capacity. When long-term rates rise, production volumes decrease and gain on sale margins generally compress as originators vie for volume through pricing.

The value of MSAs increases as long-term rates rise. This is the result of a reduction in assumed loan prepayments and lengthening of the cash flow stream resulting from fewer prepayments of mortgages. When long-term rates fall, banks assume a more rapid prepayment of mortgages as borrowers refinance their existing mortgages.

Thus, loan production and loan servicing are countercyclical to each other providing a natural economic hedge. The effectiveness of this natural hedge relies upon a bank having sufficient MSAs relative to its loan production volumes. Basel III treatment of MSAs undermines the natural hedge for banks that need it most – those that focus on mortgage banking.

Why U.S. Regulators Should Ignore Basel Commission's Treatment of MSAs

The volume and sophistication of the market for MSAs is unique to the United States. This has evolved for a number of reasons. First, the roles of Fannie Mae, Freddie Mac and Ginnie Mae, which create homogeneous pools of loans with a government express or implied guarantees, have fostered growth in the originate-to-sell market. There are no similar programs outside of the U.S. that have garnered the volume or level of sophistication that can compare to the programs and market in the U.S. Fannie Mae, Freddie Mac and Ginnie Mae have also played a major role in standardizing servicing processes and in establishing minimum servicing requirements and default processes through their respective seller/servicer guides.

Most servicing is transferable, thus creating a secondary market for the acquisition or disposition of MSAs. As mentioned above, specialty brokers assist in connecting buyers and sellers, and standardized information tapes and due diligence procedures have been developed.

The single biggest risk in the ownership of residential MSAs is the risk of prepayment. In addition to the natural hedge with respect to production volumes and margins discussed above, financial institutions frequently hedge a portion of prepayment risk through the use of various derivative instruments. We also point out that other assets on a bank's balance sheet are impacted by prepayment risk and those assets also have credit risk.

In contrast, the international markets for mortgages have been less organized and sophisticated.

The undersigned associations believe that the OCC, Fed and FDIC should take a world leadership position on this so that MSAs continue to be welcome assets in banks' portfolios with regulatory capital treatment properly set in accordance with the risk parameters of the asset. Particularly, treatment of MSAs should reflect the maturity and sophistication of each nation's mortgage and servicing markets.

Adverse Consumer Impact

The impact of the Basel III MSA treatment on consumers includes:

- Adverse risk-based capital treatment will lead to higher prices to consumers as banks attempt to price to a benchmark earnings rate on a higher required capital base. According to servicing brokers, if the reduction in value of MSAs is one multiple (25 bps), the consumer pricing impact will be from 5 to 6.25 bps. If the reduction in value is two multiples, the consumer pricing impact will be from 10 to 12.5 in bps. On a $200,000 mortgage, 12.5 bps increase costs the consumer $250 per year or $21 per month, while a 6.25 bps increase costs the consumer $125 per year or $10.40 per month.

- Banks may be forced to sell servicing in bulk or on a flow basis. Although there are protections in place for proper notification to the consumer relating to the transfer of their mortgage's servicing, such transfers can still be disruptive to consumers who like to drop their payment off at the local branch or for consumers dealing with a contact for loan modification and other such default regimes with their existing servicer.

- If banks are forced to reduce future production of MSAs, they will likely retain their existing retail and call center channels of production and exit correspondent or wholesale lending. This could adversely impact small independent lenders who generally sell loans to aggregators like large and regional banks. Accordingly, this could adversely impact consumers of those small independent lenders especially in more rural, less urban markets.

Why the Treatment of MSAs Is Too Harsh

Has a Bank Ever Failed Because of Its MSA Ownership?
No bank has failed as a result of ownership of MSAs. We do acknowledge that it sometimes takes longer to sell MSAs than other earning assets. This is true because it takes time to obtain approval from Ginnie Mae, Fannie Mae or Freddie Mac for the sale, and transferors must comply with a regulatory regime that includes letters to the consumer from both the transferor and the transferee alerting them to the change in servicers. In addition, buyer due diligence takes place as part of the process and physical and electronic transfers of files and information must take place. This process does not relate to safety and soundness issues related to the asset. Rather, the process is in place to protect consumers and investors.

MSAs Are Not Your Typical Intangible Asset
The undersigned associations believe that MSAs received adverse treatment in the Basel III, in part, because MSAs are deemed to be intangible assets under accounting rules.

We further point out that designation as an intangible is a default designation since MSAs are neither a tangible asset nor a financial asset. However, MSAs are much more liquid and have contractual cash flows unlike goodwill, trademarks, software, product formulas, and other forms of intangible assets.

Readily Marketable Asset
The undersigned associations point out that MSAs are readily marketable assets. There are brokerage firms who specialize in marketing and valuing MSA assets. Servicing is sold on a

bulk basis, whereby a portfolio of existing MSAs is sold. Servicing is also sold on a flow basis, whereby a mortgage originator sells servicing assets to be produced over a specified future period. The market for MSAs is liquid enough that the Financial Accounting Standards Board (FASB) gave reporting entities the right to elect fair value option on reporting servicing assets even before it gave the same option for reporting financial instruments.

The undersigned associations respectfully request that regulators re-examine the treatment of MSAs under Basel III with all deliberate speed. We request a meeting with you to further discuss the contents of this letter and potential harm to the traditional retail banking model.

Sincerely,

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