MORTGAGE BANKERS ASSOCIATION

March 25, 2015

Mr. Stefan Ingves
Chairman
Basel Committee on Banking Supervision
Basel, Switzerland

Reference: Consultative Document – *Capital Floors: The Design of a Framework Based on Standardised Approaches*

Dear Mr. Ingves:

The Mortgage Bankers Association[1] (MBA) appreciates the opportunity to comment on the Basel Committee on Banking Supervision's (Basel Committee) Consultative Document titled *Capital Floors: The Design of a Framework Based on Standardised Approaches* (Consultative Document). The following are MBA's responses to the Basel Committee's specific questions that are applicable to the mortgage banking industry in the United States.

Background

For banks in the United States, the rollout of Basel III included updates to the definition of capital, updates to the Standardized Approach (including risk weights for various asset categories and off-balance sheet positions), and updates to the Advanced Approach used by the largest banks. It also included specific targeted risk weights. The Basel Commission rolled out its definition of capital several years ago but did not specify minimum capital standards. The Consultative Document is for determining the appropriate capital floor based on the standardized approach.

The Basel Committee is taking this step to reduce the level of observed variation in capital ratios across banks. The actual calibration of the floor is not part of the scope of the Consultative Document.

[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 over 2,200 companies includes all elements of real estate finance: mortgage companies, mortgage brokers, commercial banks, thrifts, REITs, Wall Street conduits, life insurance companies and others in the mortgage lending field. For additional information, visit MBA's Web site: www.mba.org.

MBA's Response to Basel Committee's Specific Questions

Q1. Assuming the respective floors were calibrated to achieve the same level of required capital, what are your views on the relative merits of a risk category-based floors and an aggregate RWA-based floor? What are your views on a floor based on exposure class?

MBA's Response:

In 2010, the Dodd Frank Wall Street Reform and Consumer Protection Act (Dodd Frank Act) was passed by Congress and signed by President Obama. Included in the Dodd Frank Act was the Collins Amendment which sets minimum capital standards and risk-based capital requirements for banks and bank holding companies in the United States. The Collins Amendment set the floor for U.S. banking prudential regulators for minimum leverage ratio and risk-based capital requirements.

The Collins Amendment created an aggregate floor not a floor by exposure class. Anything that the Basel Committee does that is contrary to the Collins Amendment would require a legislative, not regulatory fix in the U.S., making it difficult to effect the change in the U.S.

Likewise, it is difficult to express an opinion on the aggregate vs. by exposure class proposals without first seeing the proposed calibration to ensure that capital levels would be calibrated consistently regardless of approach.

Q2. What are your views on the relative merits of the two options for adjusting for differences in the treatment of provisioning for credit risk?

MBA's Response:

The Consultative Document proposes two methods to convert the regulatory treatment of allowance for loan losses from the internal ratings-based (IRB) approach to the standardized approach methodology. The first approach (Option 1) is to add back or deduct, as appropriate, the allowance to or from regulatory capital and then include the general allowance for loan losses in Tier 2 capital up to 1.25 percent of credit risk weighted assets. The second option is convert the allowance to a risk weighted asset equivalent and add it to or remove from risk weighted assets when calculating the capital floor.

MBA notes that Option 1 is similar to the regime presently used in the United States for the standardized approach. We also believe that adding or deducting from capital as opposed to adding or deducting a calculated asset equivalent from risk weighted assets makes more conceptual sense since general allowances for loan losses are deemed to be capital equivalents in the calculation of Tier 2 capital.

Certain MBA members believe the examples in the Consultative Document are unclear and subject to differing interpretations, and they believe the text does not provide clear proof that either Option 1 or Option 2 are mathematically sound. Thus, MBA would like more information and examples in a subsequent exposure document.

Q3. Do you have any other comments regarding the design of the capital floor?

MBA's Response:

In its Basel Annex in 2010, the Basel Committee requires mortgage servicing assets (MSAs) in excess of 10 percent of the common equity component of Tier 1 capital to be deducted from capital. Further, it requires the aggregate of MSAs, deferred tax assets, and equity in unconsolidated subsidiaries in excess of 15 percent of the Tier 1 component of capital to be deducted from capital. The adoption of this onerous rule in the United States is forcing many traditional depositories who service mortgages to shed MSAs. Comparison of the top ten servicers shows that they have shifted from consisting of nine depositories and one non-depository to consisting of five depositories and five non-depositories since the Basel Annex was issued. The rule is also causing the shifting of servicing away from community and regional banks as well.

MSAs Are Unique to the U.S. Market

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. Specialty brokers assist in connecting buyers and sellers, and market participants use standardized information tapes and due diligence procedures.

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 below, 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 there are few MSAs recorded on the balance sheets of banks outside the United States, making the MSA issue primarily an issue for U.S. regulators.

Unfortunately, U.S. regulators moved forward and implemented the Basel Annex limits on MSAs and are reluctant to change back to a treatment less onerous.

MSAs Are 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, loan 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 Annex treatment of MSAs undermines the natural hedge for banks that need it most – those that focus on mortgage banking.

MSAs Are Not Your Typical Intangible Asset

MBA believes that MSAs received adverse treatment in the Basel Annex, 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.

As pointed out above, MSAs in the United States are readily marketable assets, unlike other intangible assets. 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.

MBA believes that future capital rules promulgated by the Basel Committee should focus on issues common to most worldwide regulators and allow country specific issues to be dealt with by each nation's respective prudential regulators. It may be too late to erase the harm to U.S. banks and the market for MSA assets, but MBA believes that the Basel Committee should withdraw the Basel Annex limits on MSA assets or at least increase the 10 percent cap and exclude MSAs from the 15 percent cap.

MBA appreciates the opportunity to share its observations with you. Any questions about the information provided herein should be directed to Jim Gross, Vice President Financial Accounting and Public Policy and Staff Representative to MBA's Financial Management Committee, at (202) 557-2860 or jgross@MBA.org.

Sincerely,

David H. Stevens
President and Chief Executive Officer
Mortgage Bankers Association