January 3, 2024

Board of Governors of the Federal Reserve System
20th Street and Constitution Avenue NW
Washington, DC 20551

Re: Docket No. R–1813, RIN 7100–AG64

Dear Sirs:

Below follow our comments on the proposed rule, "Large Banking Organizations and Banking Organizations with Significant Trading Activity."

General Comments

First, this proposal reflects a view of financial risks facing US banks that is decades out of date and ignores the public record regarding bank failures. Specifically, the Basel framework going back to the 1980s is focused on maintaining sufficient capital to absorb credit losses. Aspects of the Basel framework that address market, operational and reputational risks were added later. The primary focus of Basel remains today ensuring that banks have adequate capital to absorb credit losses, yet market risk is by far the larger concern today than in 1988.

"Events over the past few months have only reinforced the need for humility and skepticism, and for an approach that makes banks resilient to both familiar and unanticipated risks," Michael Barr, the Fed's vice chair for supervision, said in a speech in 2023 after the failure of SVB. Yet this proposal does not evidence any skepticism and, instead, seems to be defending the *status quo ante* when it comes to understanding the risks to bank safety and soundness.

The failure of Silicon Valley Bank (SVB) in Q1 of 2023 illustrates the basic flaw in the Basel III Endgame (B3E) proposal. Looking at the published data from banks collected by the Board of Governors (the "Board"), SVB had adequate capital and, indeed, boasted financial metrics that put the institution in the top half of Peer Group 1. Risk-weighted assets for Basel capital purposes were half of the bank's $217 billion in total assets.[1]

Unrealized losses reported by SVB caused a deposit run and the eventual failure of the bank. The SVB failure reflects errors by management in managing the market risk profile of the bank. The bank bought mortgage-backed securities that had zero or 20% risk weights for Basel purposes, but infinite market risk. They key lesson from the SVB failure and the near failure of several other larger institutions is that risk weighted assets (RWA) is an ineffective measure of potential loss for setting bank capital. More, large scale market risk raises questions about whether GAAP treatment of all securities should be accepted for regulatory purposes.

[1] See Bank Holding Company Performance Report for SVB Group, December 31, 2022—FR BHCPR

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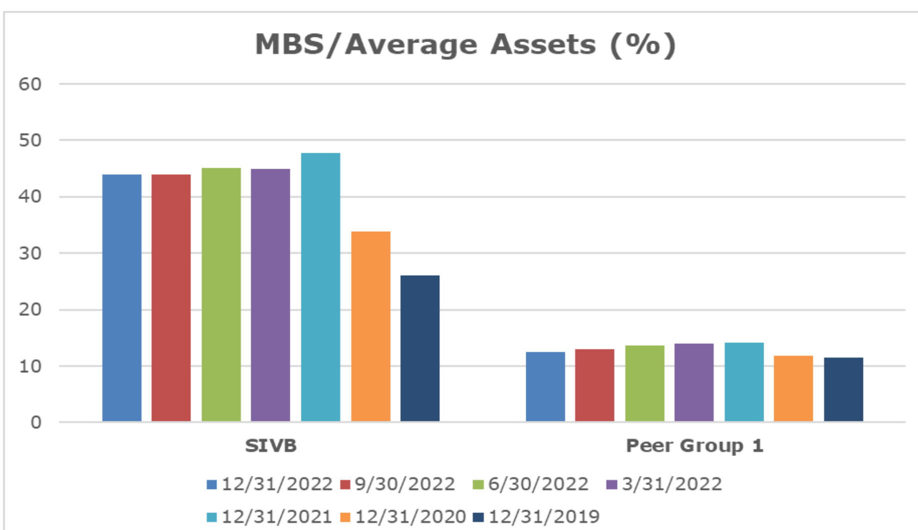
Gross nominal risk exposure – not net modelled risk metrics (DV01, CR01, RWA) – is the true measure of stress-environment risk. The mark-to-market losses facing US banks as of the date of this letter dwarf actual credit losses to banks going back a century. Interest rate volatility is the key variable when it comes to risk in 2024. The capital-centric design of Basel blinded supervisory staff into believing that SVB carried low risk. In the face of the market volatility injected into the markets by the FOMC, many banks were literally swamped by unrealized market losses on supposedly risk-free assets! As of Q3 2023, the net capital position of all FDIC insured banks was minus $1.8 trillion as shown below.

Industry Fire Sale Analysis

$M	2021 Q4	2022 Q1	2022 Q2	2022 Q3	2022 Q4	2023 Q1	2023 Q2	2023 Q2
Total Equity Capital	**$2,357,424**	**$2,257,908**	**$2,218,286**	**$2,165,245**	**$2,207,319**	**$2,262,762**	**$2,253,341**	**$2,245,224**
Intangible assets	$404,349	$415,379	$421,498	$355,596	$430,077	$435,471	$435,999	$436,192
$M	2021 Q4	2022 Q1	2022 Q2	2022 Q3	2022 Q4	2023 Q1	2023 Q2	2023 Q2
Total Capital (Tangible)	**$1,953,075**	**$1,842,529**	**$1,796,788**	**$1,809,649**	**$1,777,242**	**$1,827,291**	**$1,817,342**	**$1,809,032**
AOCI (AFS net of hedges)	$31,079	$170,176	$253,454	$347,851	$326,083	$283,309	$301,626	$336,936
$M	2021 Q4	2022 Q1	2022 Q2	2022 Q3	2022 Q4	2023 Q1	2023 Q2	2023 Q2
Total Capital (Tangible-AOCI)*	**$1,921,996**	**$1,672,353**	**$1,543,334**	**$1,461,798**	**$1,451,159**	**$1,543,982**	**$1,515,716**	**$1,472,096**
Net Loans & Leases (HTM)	$11,068,770	$11,181,401	$11,592,512	$11,815,804	$12,226,876	$12,009,849	$12,089,498	$12,131,306
M2M Adjust ($)	$276,719	$894,512	$1,738,877	$2,067,766	$1,528,359	$1,801,477	$2,115,662	$2,426,261
$M	2021 Q4	2022 Q1	2022 Q2	2022 Q3	2022 Q4	2023 Q1	2023 Q2	2023 Q2
U.S. Treasury securities (HTM)	$1,443,819	$1,481,802	$1,510,721	$1,456,722	$1,434,279	$1,326,458	$1,247,658	$1,247,123
Mortgage-backed securities (HTM)	$3,557,069	$3,522,187	$3,381,850	$3,202,320	$3,150,227	$3,032,304	$2,962,311	$2,870,131
State and municipal securities (HTM)	$423,815	$415,939	$405,028	$389,779	$384,029	$367,099	$348,528	$326,512
Total (HTM)	**$5,424,703**	**$5,419,928**	**$5,297,599**	**$5,048,821**	**$4,968,535**	**$4,725,861**	**$4,558,496**	**$4,443,767**
M2M Adjust ($)	$135,618	$433,594	$794,640	$883,544	$621,067	$708,879	$797,737	$888,753
Total Capital (Tangible-Adjusted)**	**$1,509,659**	**$344,247**	**$990,182**	**$1,489,512**	**$698,267**	**$966,374**	**$1,397,683**	**$1,842,919**
M2M Adjust (%)	**2.5%**	**8.0%**	**15.0%**	**17.5%**	**12.5%**	**15.0%**	**17.5%**	**20.0%**
10 Year Treasury Yield	**1.52%**	**2.46%**	**2.88%**	**3.83%**	**3.88%**	**3.48%**	**3.81%**	**4.59%**

Source: FDIC/WGA LLC

Even as the FOMC was pushing down interest rates in 2019, SVB was aggressively buying MBS.[2] Through 2019, 2020 and 2021, SVB maintained a level of MBS to total assets that was clearly unsafe and unsound. The bank continued to buy more and more MBS, this even as coupons fell and prepayment rates were running above 50% annualized rates. Essentially the bank's managers dug a duration hole that ultimately left the bank visibly insolvent. Short-sellers began to attack the bank's equity in the global capital markets in the Fall of 2022, but SVB was already doomed.



Source: FDIC

[2] Given that the FOMC was stating publicly that inflation would be "transitory," the banks actions might seem reasonable at first glance, but the large asset allocation to MBS was clearly reckless.

When the FOMC began to tighten policy and end asset purchases in 2021, much of the COVID era debt purchased by SVB and other banks was quickly left underwater. As the FOMC pushed up short-term interest rates, the MBS owned by SVB and other banks went from a < three-year average life to a duration in excess of ~ 15 years by the end of 2022. The FOMC created extension risk on an industry-wide scale to rival past episodes such as Kidder Peabody and Long-Term Capital Management. The chart below from *Bloomberg* shows the duration index of $2.5 trillion in Ginnie Mae MBS. Notice that the FOMC's open market operations early in 2019 account for a large portion of the downward move in duration of the MBS.

Source: Bloomberg

B3E and the previous iterations of Basel focus on "risk weighted assets," yet nominal assets are what really mattered in the case of SVB. Whether the assets were held "available for sale" or "held to maturity" did not matter. Again, the key lesson regarding market volatility that remains unaddressed by this proposal is whether all bank owned securities should be marked-to-market as a matter of regulation.[3] The key factor in the case of SVB and other banks that came under pressure, such as **Charles Schwab (SCHW)**, was the level of market volatility and how investors reacted to visible changes in the bank's tangible net worth. As a result of volatility introduced into the market by the FOMC's open market operations, as we discuss below, government-backed assets like Treasury debt and mortgage-backed securities (MBS) became a source of systemic instability.

In addition, during the market volatility in the first half of 2023, the Liquidity Coverage Ratio (LCR) regulations adopted previously by the Board contributed to the liquidity predicament. The LCR forced large banks to concentrate holdings in a restricted set of assets, which regulators prescribe as inherently low risk but actually are not (HQLA-1, HQLA-2). When stress conditions exploded in Q1 2023, banks tried to exit these "crowded," high-risk trades, causing sudden asset price depreciation and illiquidity spirals. This forced central banks to become the buyers and repo lenders of last resort. The B3E continues this discredited regulatory approach. Because of these evident flaws, the Board should consider modifying or eliminating entirely the LCR.

We applaud the change in the proposal eliminating the use of internal models for credit and operational risk currently included in Category I or II capital standards. We have always believed that the regulatory agencies need set the "normal" model baseline for the industry and compel the covered institutions to publicly explain any significant deviations from the group mean. But the SVB failure begs the question as to whether the Fed and other agencies are up to the job of characterizing bank business models.

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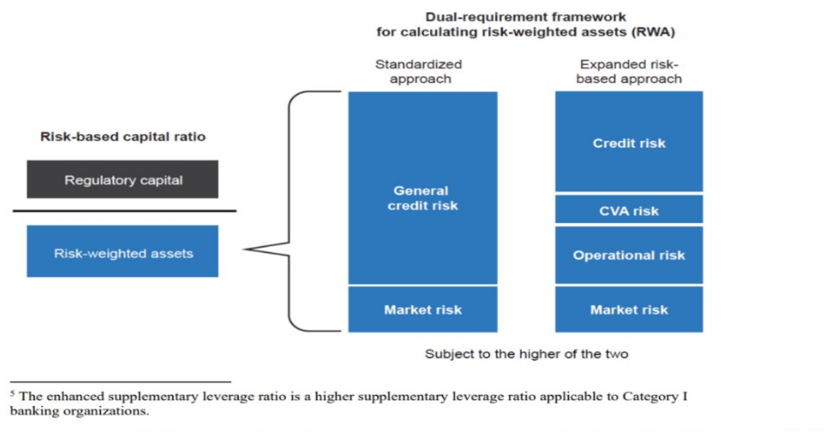
[3] See Lex, "Financial services: bank runs stoke accounting debate," *Financial Times*, December 26, 2023

How do we get supervisory personnel to better recognize bank business model differences? Forcing supervisory staff to model bank behavior using existing regulatory data is a good place to start. On 12/31/2022, when SVB reported 43% of total assets in MBS vs the 12% average for Peer Group 1, that was obviously a huge red flag. The bank reported similar data for four years previously. Yet the regulatory dog did not bark in the night. Why not?

We disagree with the continued use of a dual track approach for setting "risk-based capital" as shown below. Note in the graphic that credit risk is still clearly shown as the main element of B3E, this even though the change in tangible capital caused by recent market volatility is an order of magnitude greater than the maximum net annual credit losses to banks over the last 50 years.



Regulatory agencies should set a single standard for bank compliance using the existing public data and peer group benchmarks. Since the agencies are eliminating internal bank models for the purpose of setting risk-based capital, then why do we even need two approaches to measuring capital adequacy? After all, once we go below Peer Group 1 in terms of asset size, most depository institutions should simply be exempted from B3E compliance. Yet the risk-based model that is applied to the largest banks should also be used by the supervisory agencies to conduct outlier analysis on all banks. This key element of public comparability is missing from the B3E proposal.

Peer analysis should not only look for deviations from the "normal" definition but also large skews – aka "motion" -- from historical behavior. Short-term changes in assets and/or liabilities may indicate idiosyncratic risk. For example, banks involved in relationships with customers engaged in using crypto currencies for payments and/or in partnerships with nonbank consumer lenders, for example, fit into the category of smaller banks that ought to have heightened levels of reporting and capital modeling due to credit and/or operational risk.[4]

The new set of standardized approaches for modeling bank capital under B3E should be the floor for all institutions. Banks that display significant deviations from the peer mean and other regulatory benchmarks should have higher capital requirements. By collapsing the current confused tangle of cyclical and counter-cyclical "risk based" capital requirements into a single coherent standardized view of 1) credit and 2) market risk, the Board and other agencies will improve the safety and soundness of banks.

[4] See Crossman, Penny, "FDIC order against Cross River Bank is a warning on fintech alliances," *American Banker*, May 1, 2023

Once minimum capital levels for credit and market risk are set, adding a third leg to address operational risk factors then becomes a relatively easy task based upon the particular bank's business model. Yet is must be said that a lot of credit and market risks stem from operational deficiencies. By using public *quantitative* and *qualitative data* to set clear industry benchmarks, however, the Board and other agencies will improve the transparency of bank risk factors and thereby serve the convenience and need of the public.

Take another example: Banks are increasingly seeking to sidestep ever-higher regulatory capital burdens by acting as non-principal middlemen, bypassing their own balance sheets, in order to connect end-use borrowers with direct lenders. Essentially, this resembles getting out of the risk-storage business, and into the risk-moving business, a behavior usually associated with nonbanks. Is this the outcome that the Board and other agencies intend? Obviously, banks engaging in risk-moving should be subject to heightened levels of supervision, but why are regulators pushing banks in this direction in the first instance?

We should all recall that complexity rarely leads to clarity in the world of finance. We submit that the Board and other agencies need to put aside the present proposal and seek to simplify the B3E framework if they are serious about understanding what the "cumulative effect is on safety and soundness and risks to the financial system." The current proposal continues the primary historical focus of Basel on credit risk and gives too little weight to market risk.

Specific Comments

Mortgage Servicing Assets

The proposal increases the amount of mortgage servicing assets (MSAs) and deferred tax assets (DTAs) that are deducted from a bank's capital. Currently a bank can hold MSAs or DTAs equal to up to 25% of its common equity Tier 1 (CET1) capital before a deduction from capital is made. Under the proposal, the threshold would be lowered from 25% to 10%. We strongly disagree with this change with respect to MSAs, but agree on DTAs. The Board and other agencies need ponder the difference between these two supposedly "intangible" asset classes. Are MSAs really intangible? Or merely derivative assets with cash flows that are difficult to describe.

US regulators operate from the false assumption that MSAs represent a risk to banks, but this is inaccurate. MSAs are valuable, naturally occurring negative-duration assets with periodic cashflows. MSA also contain valuable embedded options that are not recognized by GAAP. The real issue that caused regulators in the US and Europe to adopt a negative view of MSAs is the unsafe and unsound behavior of a few large lenders such as Countrywide, Washington Mutual Bank, Bear Stearns, and Lehman Brothers. Loan defaults, not MSAs, caused the failures of these banks, yet the large equity investments in servicing assets are blamed for subsequent credit losses.

The credit defaults of private residential mortgage loans, not their loss-mitigation servicing, caused the collapse of many bank and nonbank lenders in 2008. In fact, the private label MSAs from that period have proven remarkably stable over the past 15 years.[5] Countrywide and WaMu were technically "banks," but the business model was of nonbank origin, leveraged by FDIC insurance and excessive debt, to originate and sell subprime loans to the GSEs and into MBS.[6]

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[5] Select Portfolio Servicing is owned by Credit Suisse/UBS AG.

[6] Citibank N.A. launched the first bank-issued subprime residential loan product, "Mortgage Power," in the 1980s and offered the product globally. Mortgage Power was a financial disaster for the bank.

If regulators truly understood the positive role of negative duration MSAs in preserving and growing bank capital, the Board would be seeking to *lower* the capital requirement for MSAs. Specifically, the Board should reverse its position and instead encourage banks to originate and retain mortgage servicing as a counter-cyclical capital buffer and interest rate hedge.

Half a century ago, banks that originated residential mortgages retained the loans on balance sheet and never recognized a separate MSA. The servicing asset was simply part of the value of the loan – and a long-term capital asset for the bank. MSAs were an invisible and very tangible source of liquidity for the bank, especially during times of elevated credit losses. For many banks, retaining sufficient servicing to cover the bank's operating expenses during times of economic stress was a key goal. The fees and float from an ample servicing book allowed the depository to focus all of net interest income on loss mitigation, thereby preserving bank capital and adding stability to the industry and the financial system.

In more recent times since 2008, regulators in the US and Europe have waged a relentless campaign against MSAs and residential mortgage assets more generally. European regulatory agencies in particular reflect an obsessive political bias against single-family homes that is not in keeping with American economic interests and values. The groundswell of opposition to the subject proposal from all parts of the US mortgage finance, home building and real estate finance sectors evidences this concern.[7] We believe that the Board and other agencies face the prospect of a political rebuke by Congress should these changes not be dropped.

Why are regulators worried about MSAs? Largely because of interest rate volatility caused by the actions of the FOMC. The valuation of MSAs, which reflect the net present value of the cash flows from the servicing asset, are generally modelled and are a function of interest rates and other factors. Regulators worry that in times of severe interest rate volatility such as in 2020, MSAs and all other bank assets, can become a source of instability to banks. As prepayments rise and valuations fall, margin calls can quickly consume available cash. But there are several important caveats that mitigate these concerns.

First, in a falling rate environment, lenders tend to replace MSAs faster than the runoff due to prepayments. Indeed, if the Board inspects the public record, they will see that the fair value of MSAs owned by banks and nonbanks actually remained stable in 2020 even though banks did not fully participate in the surge in mortgage lending in 2020-2021.[8] Yet JPMorgan, the largest residential servicer in the US, has grown its over $1 trillion servicing portfolio of mostly prime jumbo mortgages steadily over the past decade.

In times of rising interest rates, both banks and nonbanks benefitted from the increase in the fair value of the MSA as prepayments slowed, the NPV of periodic cash flows extended and the value of escrow balances increased. Some owners of MSAs may choose to sell servicing as part of a natural hedge against falling lending volumes. This is a perfectly sound and, indeed, appropriate financial strategy, yet this proposal would discourage small banks from retaining MSA as a hedge against lending risk.

As mentioned above, smaller banks tend to retain the MSA and sell the mortgage note. MSAs do fluctuate in value based on models and the movements of interest rates, but here's the key question: So what? The volatility of deeply out of the money MSAs is far less sensitive to rate movements

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[7] See Mortgage Bankers Association Summary on Basel III

[8] See Bancroft, John, "Nonbanks Keep Growing MSR Share, Delinquencies a Potential Concern," *Inside Mortgage Finance*, February 2, 2023

than in the past, but at the money MSAs are still subject to significant fluctuations in value as interest rates move and the possibility of loan refinance events changes. Significantly, the risk of extinguishment of MSAs is small and over the past half century has been limited to small defaults by banks and nonbanks, usually related to government servicing assets.[9]

Interest rate hedges are used by both publicly traded banks and IMBs which own MSAs, but mostly as a matter of investor relations to mute published earnings volatility. Most Ginne Mae issuers, for example, do not hedge their MSAs, accoding to that agency's issuer disclosure statements. Hedges can dramatically reduce the visible interest rate/valuation risk associated with the MSA without expending significant hedging costs (i.e. hedge the duration not the negative convexity). The fact remains, though, that the hedge of the MSA is unnecessary from a duration perspective. A lender that holds mortgage loans and MSAs in portfolio is essentially hedged.

Second, the volatility in interest rates that caused the failure of SVB and seems to drive the regulatory concern about MSAs is a function of monetary policy. This proposal never once mentions the impact of the manic swings in interest rates as a result of the polices of the FOMC from 2019 through 2024. Excessive swings in interest rates are an externality over which banks have no control. Why are regulatory agencies penalizing banks for the policy machinations of the FOMC? More, how do higher capital risk weights help the supposed price volatility of MSAs? [10]

The Board and other agencies should keep in mind that the "volatility" of MSA pricing is largely a mirage caused by models employed by publicly traded issuers. Private issuers generally do not hedge the MSA valuation because they understand that the lending side of the business is a natural, positive duration hedge for the MSA.[11] Public companies try to limit the "noise" to earnings from the swings in reported MSA valuations, but in reality, the MSA ought to be carried at book value as a *tangible asset* and simply marked to actual prepayments each month.[12]

Rather than erecting artificial barriers to bank holdings of MSAs, the Board should actually *decrease* the capital requirement for MSAs to 100% and place a fixed limit on MSA holdings vs capital subject to supervisory oversight. If the bank has competence in originating residential mortgage loans and managing MSAs as part of a formal Asset Liability Committee (ALCO) strategy, and many do, then the activity should be encouraged with lower capital treatment. As with the capital rules generally, the Board and other agencies need to develop a better understanding of the operations of individual banks rather than setting arbitrary limits that make little sense financially and in prudential terms.

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[9] Whalen, Richard Christopher, Assessing Involuntary Termination Risk on Residential Mortgage Servicing Rights (March 17, 2017). Available at SSRN: https://ssrn.com/abstract=2936422

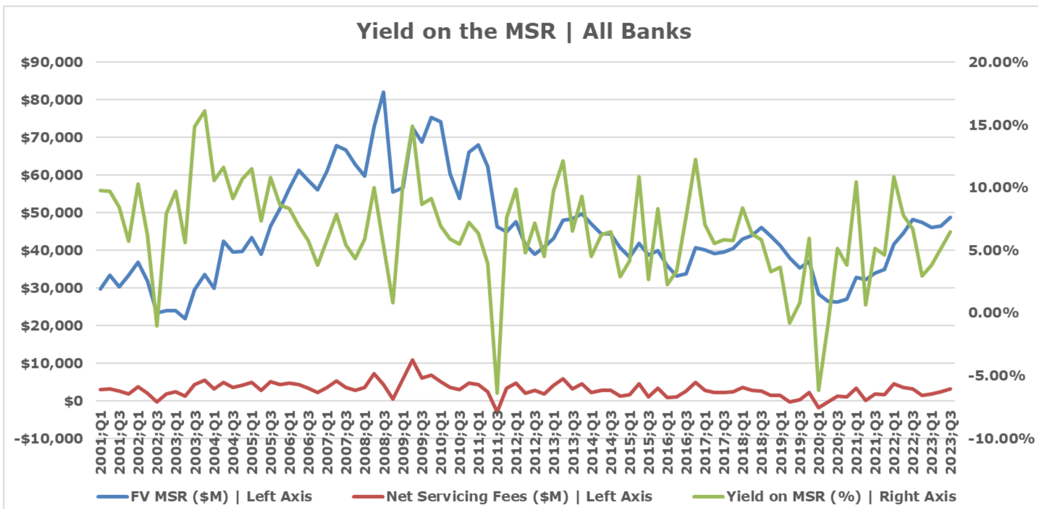
[10] FDIC Chairman Martin Gruenberg said on September 20, 2023: "Mortgage servicing rights, whose value is volatile and highly dependent on models and subjective judgement, typically represent multiples of a nonbank mortgage company's equity capital." This statement apparently originates from the risk function of Ginnie Mae, which has never provided any public justification for this view. In fact, as the public record demonstrates, MSAs are extremely stable assets for all lenders and MBS issuers.

[11] Privately owned nonbanks, for example, do not generally hedge the short-term valuation changes of the MSA and instead spend capital on increasing new loan originations and acquiring MSAs.

[12] The GAAP characterization of MSAs as a *payment intangible*, Level 3 asset is false. In fact, MSAs have very good secondary price histories similar to Level 2 assets and are easily valued every single day. The Board should encourage the SEC and FASB to reassess the accounting presentation of MSAs.

Thirdly, the US approach to MSAs reflects a degree of financial naivete that is breathtaking. Far from being a threat to banks, MSAs are one of the most valuable assets that a bank can originate and retain, especially in a rising interest rate environment. Many bank MSAs today, as a century ago, are not even recognized on bank balance sheets because the mortgage note is never sold. These originated or "OMSAs" are part of the gross value of the loan asset and represent a very tangible capital asset and source of repeating cash flow for the bank. OMSAs tend to have a cost basis far below the average secondary market price for MSAs. It is notable that, given the apparent view of these assets as being "risky," the Board's proposal does not include OMSAs.

The unlevered cash yield on MSRs is shown below. It is typical to put at least 50% leverage under the MSA, thus the effective yield on these assets can be well into the teens. This proposal will reduce bank holdings of MSAs further and increase the nonbank share of residential mortgage lending and servicing. Is this the outcome that the Board and other agencies are seeking?



Source: FDIC/WGA LLC

Conventional MSA's traded in the secondary markets have higher valuations because of the growing audience for these assets. Yet even with more and more investor capital chasing the MSA, <u>the assets still trade at a considerable discount to the NPV of the cash flows of other commercial assets</u>. New issue capitalization rates for conventional MSAs averaged around in 4-5x annual cash flow in Q3 2023 depending on the composition of the related MBS pools. Yet commercial real estate and other commercial assets trade at capitalization rates twice these levels. The effective yield on the MSA is often well into double digits, multiples above the gross yield on many other bank assets. Why is this bad?

Take an example; Under the B2E proposal, a CRE exposure warrants a 100% risk weight but the residential MSA, which has zero credit risk and transparent prepayment risk, somehow warrants a punitive 250% capital risk weight and a 10% threshold for further punitive capital deductions? The largest recent global economic shock, Covid-19, caused a secular, double-digit decline in value for CRE assets, yet has not impaired residential MSAs even as the FOMC raised interest rates. The subject proposal ignores this fact. Data collected from banks by the Board and other agencies strongly refutes the Board's approach to MSAs in this proposal.

When we speak about bank exposures to 1-4 family mortgages and MSAs, we are talking primarily about conventional loans and derivatives. Previous regulations by the Board have largely driven commercial banks out of government lending and Ginnie Mae MSAs. Banks are easily able to fund any advances required on the conventional servicing asset. MSAs related to Ginne Mae MBS, however, have higher operational risks and liquidity requirements. This is why banks have largely exited government lending and servicing since 2008. The Board and other agencies participating in this rule making exercise need to differentiate between conventional and government loans.[13]

Another positive factor arguing in favor of lower risk weights for all MSAs is the value of recapture. The MSA represents the lender's relationship with a customer. Under GAAP, however, the 'recapture" of a loan servicing asset is not recognized in the fair value of the MSA. This is yet another shortcoming in the GAAP accounting presentation of mortgage servicing assets and other "payment intangibles." When recapture is included in the GAAP fair value for the MSA, the potential for a recapture event represents years of servicing fees. This fact makes the MSA a clear home run for the bank or nonbank lender, yet B3E would essentially prohibit most bank investments in MSAs. Is this really the policy goal that the Board and other agencies intend?

Another inconsistency in the Board's approach to risk weighting MSAs is illustrated by an example. If we accept that the concept of "hedging" MSAs is done mostly for appearances and only by a minority of issuers, then negative duration MSAs could be an excellent hedge to positive duration loans and MBS held on balance sheet. As part of an effective ALCO strategy, MSAs ought to receive hedge treatment under B3E rather than 250% risk weighting. Compare the far smaller risk weight that this proposal affords to say "AAA" rated I/O securities and interest rates swaps used for precisely the same type of hedging. Do the Board and other agencies really believe that MSAs are an inferior duration hedge for a bank compared to using volatile I/O securities and swaps?

Finally, the Board and the agencies need to consider how the proposed changes to the capital treatment of MSAs for B3E will interact with the pending Risk Based Capital proposal from Ginnie Mae (See Appendix). Despite the title, the Ginnie Mae "RBC" proposal is inconsistent with the Basel framework and is even more punitive to non-banks than the subject B3E proposal is to banks. Under the Ginnie Mae proposal, nonbank issuers would not be able to put even 50% leverage under the MSA, making the asset unattractive as an investment. The Board needs to take notice of the Ginnie Mae proposal in considering this rule.

In considering MSAs, the Board and other agencies need to ask a basic question: Do we want to destroy the market for residential mortgage finance in the US? The cumulative effect of the proposals from the Board and Ginnie Mae could make government loans and Ginnie Mae MSAs, for example, unattractive for investment by most financial institutions. In an extreme scenario, the Treasury could be forced to take ownership of forward and reverse Ginnie Mae MSAs, as in the case of the bankruptcy of Reverse Mortgage Investment Trust in November 2022.[14] The Board, prudential regulators and officials of Ginnie Mae all need to reconsider their collective position on MSAs before we face disaster in the market for government loans.[15]

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[13] The GSEs reimburse the expenses of conventional issuers after month four, effectively terming out the risk exposure on the delinquent loan. Ginnie Mae issuers, on the other hand, must finance the delinquent loan asset indefinitely until final resolution, which puts downward price pressure on related MSAs. Ginnie Mae MSAs with high levels of loan delinquency have negative values and thus become "mortgage servicing liabilities."

[14] See *Reverse Mortgage Investment Trust*, U.S. Bankruptcy Court, District of Delaware (Delaware), Bankruptcy Petition #: 22-11225-MFW

[15] See Matsuda, Akio, "Texas Capital Bank Sues Ginnie Mae Over $28 Million Bankruptcy Loan," *The Wall Street Journal*, October 3, 2023

Since 2008, US regulators have been engaged in a policy of intentional discrimination against MSAs that, at times, seems nonsensical to professionals working in the mortgage industry. The flawed thinking among Board staff and other agencies has polluted the policies of housing agencies such as Ginnie Mae, which mimic the Basel framework without the benefit of understanding or the enormous time and effort spent developing the capital framework.

Banks and nonbanks alike have an interest in holding MSAs over the long-term, yet the direction of the US regulatory community is making this impossible. Prudential regulation for the sake of putting arbitrary capital requirements on depositories and nonbank issuers will only hurt consumers by making residential mortgages more expensive. This proposal also will reduce the liquidity and profitability of banks and nonbanks alike by reducing investment in MSAs and whole loans. Again, MSAs are one of the most profitable investments a bank can own.

Or to put it another way, if the Board and other prudential regulators really, *really* believe that MSAs are unsafe and unsound for investment by banks, then the Board should force banks to divest all MSAs. The Board should also prohibit banks from making secured commercial loans or default servicing advances against all MSAs of all types. Go ahead and shut down the US mortgage industry. The Board should tell JPMorgan, Wells Fargo, U.S. Bank, NYCB/Flagstar et al to sell their servicing assets and wind down warehouse lending. Within about a week, the Board can expect to see legislation introduced in Congress reversing the action.

Residential Mortgages & MBS

The current standardized approach of Basel III assigns a 50% risk weight for prudently underwritten mortgages that are current or a 100% risk weight otherwise. The new proposal would assign risk weights that rise in increments from 40% to 125% depending on the loan-to-value (LTV) ratio and whether the mortgage is dependent on cash flows from the property, such as rent. There are several problems with the proposal and also with current regulation.

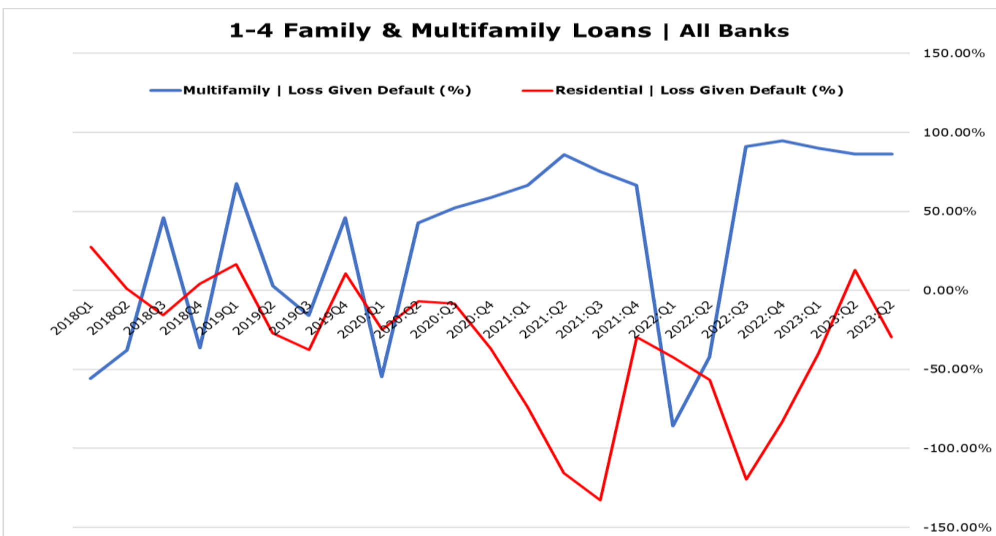
First, it is unclear why the Board chose to address rental income for investment loans in the same section as owner-occupied residential loans. Business purpose loans (BPLs) are actually small commercial loans and should be treated separately from residential mortgages. While the collateral and documentation used in BPLs is very similar to residential mortgages, these small balance loans are exempt from most consumer regulation. BPLs belong in a commercial category rather than being grouped with owner-occupied residential mortgages.

Second, current regulations going back to the original Basel proposal place a 50% risk weight on a well-underwritten residential mortgage. Current law and the subject proposal do not seem to differentiate between residential mortgage loans that have GSE or government guarantees, and private loans. On private loans that are not eligible for pooling into conventional or Ginnie Mae MBS, the adjustment to LTV is appropriate but not solely based upon rental income. Using the guidelines from the credit ratings community, ultimately the asset behind a mortgage loan is the primary security. Maximum LTVs of 50% are appropriate for private label mortgages as with commercial assets since the individual obligor generally provides little effective credit support.

For conventional and government insured loans, however, the current regulation and this proposal make no sense. Regulators believe that a GSE-guaranteed asset is risky, yet are silent about the actual legal process of reimbursing conventional issuers? So long as the GSEs are in conservatorship, the current 50% risk weight for a conventional loan is clearly too high. As noted above, the conventional issuer is reimbursed <u>for all expenses on a delinquent loan by a GSE after four months</u>. What purpose does the current 50% risk weighting on a conventional loan serve given that there is no credit risk to the bank? A loan endorsed by one of the GSEs (or FHA) is effectively a T-bill from a capital perspective and may be financed on those terms in the repo market. The agencies ought to set the risk weight for conventional loans equal to the risk weight for the conventional MBS, namely at 20%. Given that a loan can only be leveraged 1x but an MBS can carry double digit turns of leverage, an additional market risk charge for MBS is clearly warranted separate from credit risk. The B3E proposal is silent on this key distinction.

With a government insured loan, however, the risk to the government issuer is *higher* than on a conventional loan because reimbursement for expenses is only partial and often is not timely. Despite the explicit government insurance on the mortgage note, the government issuer must contend with the Byzantine operating rules of the Federal Housing Administration and other agencies that guarantee the mortgage note.[16] The servicer of a delinquent government-insured mortgage note often suffers a net cost on loss mitigation and servicing, but makes far more profit on new government loans than on conventional loans. Net, net, the risk weight for the bank owner of a government insured mortgage and/or MSA should be *higher* than the conventional mortgage.

As the chart below illustrates, the cost of default for $2.5 trillion in bank owned 1-4 family mortgages has been negative since 2018, but the LGD on multifamily loans is above the LT average of net loss.



Source: FDIC/WGA LLC

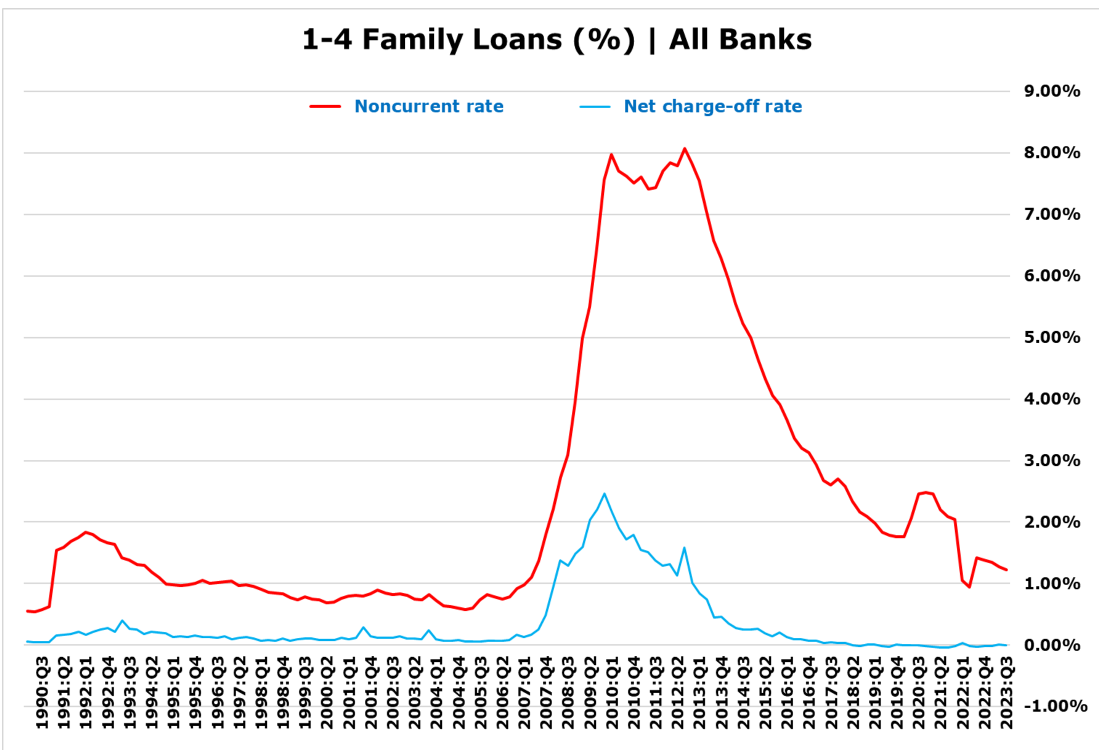
Given the inferior credit characteristics of a government mortgage, we suggest that the agencies keep the minimum risk weighting on government-insured mortgage notes at 50%. Since only a few banks remain in the government market, this should not be a concern for the industry. One key question the Board need consider is whether there should be a *higher* risk weight for Ginnie Mae MSAs vs conventional MSAs. This is the approach taken by the Federal Housing Financial Agency with respect to capital requirements for nonbank conventional issuers that own Ginnie Mae MSAs.

[16] In the event of a default and foreclosure on government insured mortgage, the servicer can expect to lose thousands of dollars during the loss mitigation and conveyance process. Also, government lenders are reimbursed for interest expense at the debenture rate, not at the true cost of financing, ensuring that the government lender will take a loss on financing the delinquent loan and related advances.

Privately underwritten residential mortgages were 50% of the mortgage market in 2008 and a significant source of loss to banks, but the changes to the market since that time have dramatically lowered the risk profile of this asset class. In January 2024, virtually all residential mortgages are fully documented and 98% of these mortgages are insured by the GSEs or the FHA/VA/USDA. More, loss given default (LGD) on bank owned 1-4s has been negative for years.

If the agencies take notice of the public record and some of the previous comments by industry observers, then the proposed increase in the risk weights for all bank-owned 1-4 family mortgages seems to be badly considered.[17] The risk weight for multifamily mortgages, on the other hand, probably needs to be increased to reflect changing market conditions and political concerns. The 2019 rent control legislation in New York, for example, has essentially made a whole class of rent stabilized multifamily assets in New York State toxic for banks.[18]

The subject proposal seems to be out of line with the changes in the mortgage industry over the past decade and the public record regarding bank loan losses. The existing 50% risk weight represents 4% capital behind the risk asset or 2x the historical peak net loss rate (2.47%) for 1-4s from the 2008 experience. How do the Board and other agencies justify this proposal? Even if we ignore the credit risk insurance provided by the GSEs for conventional loans, the current risk weight for residential loans is clearly too high looking at net loss rates. The proposed changes are even less justified looking at the public record.



Source: FDIC

[17] See Laurie Goodman and Jun Zhu, "Bank Capital Notice of Proposed Rulemaking A Look at the Provisions Affecting Mortgage Loans in Bank Portfolios," *Urban Institute*, September 2023,

[18] See "Albany's Toxic Rent Control Plan," *The Wall Street Journal*, October 22, 2023

While the proposed risk weights for 1-4 family loans in this proposal are clearly too high, the Board and other regulators need to take another look at the market risk weights for conventional and government MBS. These securities are all government insured to some degree against credit loss, yet the peculiar market attributes of MBS make these assets problematic for many banks. The market volatility that makes MSAs *appear* risky makes MBS very dangerous as a matter of fact. This proposal largely ignores the very real risk from MBS and instead mistakenly demonizes whole loans and MSAs.

We shall be happy to answer any questions about this comment.

Yours sincerely,

R. Christopher Whalen
Chairman

Appendix

Ginnie Mae Risk Based Capital

The calculation is from Chapter 2 of the Ginnie Mae Guide which, of note, was included inadvertently after APM 22-11. Ginnie Mae subsequently pushed out the implementation date until December 31, 2024). It reads as follows:

> (d) Effective December 31, 2023, single-family Issuer applicants that are not covered by the requirements for financial institutions shown above (in MBS Guide Chapter 2, Part 9, § B(2)(a), and § B(2)(b)), in addition to maintaining the Leverage Ratio in Part 9, § B(2)(c) described above, must maintain a Risk-Based Capital Ratio (RBCR) of at least 6%. RBCR is Adjusted Net Worth ("ANW") modified for Excess Mortgage Servicing Rights ("MSRs") divided by total Risk Based Assets.
>
> $$RBCR = \frac{\text{ANW - Excess MSRs}}{\text{Risk Weighted Assets}}$$
>
> ANW is defined in Chapter 2 Part 9, § D of this Guide. For purposes of the RBCR only, ANW will be modified by subtracting Excess MSRs. Excess MSRs are defined as MSRs in excess of an applicant's or Issuer's ANW.
>
> Total Risk-based Assets are defined as total assets that are risk-weighted according to the following schedule:

Ginnie Mae argues that its ersatz definition of risk-based capital is more liberal than Basel III, primarily because the Ginnie Mae proposal deducts significantly less of total MSRs from Adjusted Net Worth (ANW). ANW is defined as equity less certain unacceptable assets. Basel III currently requires that any MSRs exceeding 25% of Common Equity be deducted from Common Equity Tier 1 (which is equivalent to ANW for Ginnie Mae purposes). RBCR deducts MSRs from ANW only when MSRs exceed 100% of ANW.

The Ginnie Mae position is absurd, however, because its risk-based capital rule is applied not to banks, but nonbank finance companies. Nonbanks lack the ample liquidity and public subsidies allocated to federally insured banks, thus the comparison is inappropriate. Like securities firms, for example, nonbank mortgage lenders tend to have at least 100% of net working capital invested in loans/securities intended for sale. While securities firms deduct all intangibles from net capital, leverage and other rules regarding risk are far more liberal than for banks.

The MSA represents an important vehicle for banks and nonbanks to accumulate incremental capital and generate higher revenues via loan recapture. MSAs are a crucial, long-term capital asset for MBS issuers, banks and nonbanks alike, that ought to be encouraged rather than attacked and diminished. If we take notice of the double-digit rates of equity returns achieved historically by large Ginnie Mae issuers, firms that typically have built substantial portfolios of MSAs without hedging, it is difficult to support the adversarial position of the Board and other agencies in this proposal.

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