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From: Erin Frederick [mailto:Erin@CanfieldAssoc.com]
Sent: Wednesday, June 07, 2000 5:23 PM
To: 'public.info@ots.treas.gov'
Subject: Consumer Mortgage Coalition's Recourse Rule Comment Letter

To Whom It May Concern:

Attached is the Consumer Mortgage Coalition's Comment Letter on Risk-Based Capital Standards; Recourse and Direct Credit Substitutes. We
have attached the letter in PDF format. However, we can resubmit a letter
in Microsoft Word if necessary.

If you have any questions or difficulty opening the attached letter,
please contact Erin Frederick at (202) 544-3550 or at erin@canfieldassoc.com
<mailto:erin@canfieldassoc.com> . Thank you.

<<CMC Recourse Rule Comment Letter.PDF>>

# *CONSUMER MORTGAGE COALITION*

June 7, 2000

Docket No. 00-06
Communications Division
Office of the Comptroller of the Currency
250 E Street, SW
Third Floor
Washington, DC 20219

Ms. Jennifer J. Johnson
Secretary,
Board of Governors of the Federal Reserve System
20th Street and Constitution Avenue, NW
Washington, DC 20551

Mr. Robert E. Feldman
Executive Secretary
Attn: Comments/OES
Federal Deposit Insurance Corporation
550 17th Street, NW
Washington, DC 20429

Manager,
Dissemination Branch,
Records Management and Information Policy
Office of Thrift Supervision
1700 G Street, NW
Washington, DC 20552

Re: Risk-Based Capital Standards; Recourse and Direct Credit Substitutes

Dear Sirs/Madams:

The Consumer Mortgage Coalition (the "CMC"), a trade association of national mortgage lenders and servicers, is pleased to submit these comments in response to the Joint Notice of Proposed Rulemaking published by the four agencies on March 8, 2000 to address the regulatory capital treatment of recourse obligations and direct credit substitutes under the risk-based capital standards that apply to insured depository institutions.

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We commend the regulators for the substantive work that has been done to improve and modernize these regulations with this proposal. However, several significant issues for mortgage lenders and servicers remain in this proposal. Specifically:

- Ratings-based risk weightings for mortgage backed securities will have numerous positive effects for issuers and the mortgage market, in general.
- Recourse treatment of loan or servicing sale representations and warranties as proposed is too broadly defined and will result in a significant cost burden to the industry.
- Premium refund clauses are unrelated to credit quality and, therefore, should be omitted from any recourse treatment proposal.
- Single-family 1 to 4 unit residential properties should be specifically excluded from recourse treatment in accordance with industry practices and the narrower liability afforded to residential property owners.
- The limit on non-reimbursable servicing advances should be eliminated as impractical, unlikely to have any positive effects, and may have the unintended consequence of a discriminatory impact on home buyers in the lower income segments of the market.

**Comments**

***A. Risk Weighting of Private Mortgage-Backed Securities***

The proposed rule moves away from fixed risk weightings and towards a ratings-based approach that measures relative exposure to credit risk as a way to determine the appropriate regulatory capital treatment. In particular, current capital regulations apply a fixed risk weighting of 50 percent for privately issued mortgage backed securities backed by whole residential mortgages. The proposed rule would substitute a ratings-based approach so that mortgage-backed securities that receive the highest or second-highest credit rating would be accorded a 20 percent risk weight. Lower-rated mortgage-backed securities would receive higher risk weighting, according to the amount of credit risk involved. (See the sliding scale of rating categories and risk weights at p. 12328 of the *Federal Register*, March 8, 2000).

The CMC agrees with the four agencies, and with the Basle Committee,[1] that the ratings-based approach has many advantages over the older system of fixed risk weightings. Most important, the ratings-based approach promotes safety and soundness of financial institutions by creating incentives for them to manage the credit risk of their transactions and holdings. By failing to give credit for less risky assets and by giving a fixed risk weight for more risky assets, the older system of fixed risk-weightings reduced the incentive of institutions to manage the credit risk of their holdings.

[1] See, "A New Capital Adequacy Framework," consultative paper issued by the Basel Committee on Banking Supervision, June 1999.

Indeed, as Chairman Alan Greenspan and others have stated, the system of fixed risk weightings actually encouraged regulatory arbitrage. This occurred because of the correlation of risk and return on an asset; financial institutions had an incentive to reduce their holdings of low-risk assets and increase their holdings of higher risk assets as a way to obtain higher returns without disturbing the risk-based capital treatment of their portfolios.

Moving to a ratings-based approach for private mortgage-backed securities will have a number of positive effects. Financial institutions will gain an incentive to manage the credit risk of the private mortgage-backed securities that they hold, as a way to become eligible for a lower risk weighting. They also will lose much of the incentive to engage in regulatory arbitrage; under the proposed capital rule, a shift in credit quality of mortgage-backed securities in an institution's portfolio will generate a commensurate change in regulatory capital treatment.

In other words, under the current capital standards, insured depository institutions are encouraged to invest in MBSs issued by the GSEs rather than privately issued AAA or AA-rated MBSs. By removing this disparate treatment, the proposed rule will help to move the risk-based capital system to one that more closely aligns risk-weightings with real risk.

In support of the risk weightings proposed, Table 1 compares the proposal with results from a study completed by Standard and Poor's ("S&P") regarding rating transitions (downgrades and upgrades). In this study, S&P reviewed residential mortgage-backed security issuance from 1978 through 1999. S&P was interested in the stability of credit ratings over time and found that on an annual basis, the transition ratio averaged only 0.6%. Rating upgrades were more frequently related to the performance of the collateral (90%) than an upgrade of a third-party credit guarantor (10%). For rating downgrades, the opposite was true: 62% were due to rating downgrades of the guarantor and 38% were due to collateral performance. Of the rating downgrades related to guarantors, 82% resulted from the 3 consecutive downgrades of one guarantor, Citibank N.A., in 1990 and 1991.

**Table 1: Proposed Risk Based Capital Requirements in Comparison to Reported Downgrades and Defaults**

| S&P Rating | Proposed Risk Weight | Capital Requirement* | Downgrades** | Defaults** |
|---|---|---|---|---|
| AAA | 20% | 1.6% | 1.0% | 0.1% |
| AA | 20% | 1.6% | 13.2% | 1.5% |
| A | 50% | 4.0% | 6.0% | 1.0% |
| BBB | 100% | 8.0% | 6.5% | 1.5% |
| BB | 200% | 16.0% | 6.3% | 2.5% |
| B | "Gross Up" | TBD | 8.7% | 6.2% |

* Based upon an 8% minimum risk based capital ratio.
** Source: *Performance of U.S. RMBS Credit Rating, 1978 – 1999*, Standard & Poor's Rating Services

Table 1 illustrates that the percentage of defaults reported by S&P is, in most cases, considerably less than the proposed capital required using the 8% minimum ratio. The exception is in the "AA" category where defaults are 0.1% less than the proposed minimum capital requirement. However, if the default percentages from the highest to lowest ratings are carefully examined, it is clear that the "AA" category is not in line with the others. S&P explains that nearly all of the 18 defaults of securities initially rated "AA" were transactions of one issuer, and the defaults were likely the result of poor underwriting and servicing, as well as complete loss of the credit support. (Note that of these 18 defaults, 7 defaults occurred from a transition rating of "B", and an additional 7 occurred from a rating of "CCC" or below. (Thus, any holder of these securities would have had sufficient warning of an impending problem.) If we assume that a more typical default ratio is somewhere between the 0.1% reported for "AAA" and 1.0% for "A", the "AA" default ratio is significantly less than the proposed capital requirement, as well.

***B. Representations and Warranties***

We agree with the focus of the current proposal regarding the allocation of credit risk within representations and warranties. With regard to early default clauses, however, we agree with comments that were made to the 1997 Proposal stating that these clauses are intended to deal with the inadvertent transfers of loans that are already delinquent, as well as loans that are about to become delinquent. Early default clauses assure the buyer of the loan quality at the time of purchase. Through this assurance, these clauses lower the costs associated with loan sales by avoiding a more intensive and expensive due diligence process. Their intent is not to provide the buyer with a credit guarantee but to expedite the transaction and, as such, the risk involved is of an operational nature. That said, the operational nature of such a clause might become a credit guarantee as the term of the clause lengthens. Thus, we would support a sale as a non-recourse transaction with an early default clause term of three or four months. Although this is a subjective test, a term longer than a few months begins to resemble a credit guarantee. A term of a few months, however, is relatively short and generally provides buyers assurance that they are receiving what was purportedly being sold.

Only alluded to but extremely important is the impact of shifting quality and conformance representations to recourse on market liquidity. If this change impacts GAAP sale treatment, it would occasion on a substantial front end due diligence introducing material market risk into trades that are done today based upon the standard quality assurance of representations and warrants. Even if this does not impact sale treatment the entire economic assessment regarding sale will be impacted in a way that damages whole loan liquidity. This is home owner cost over a non-issue in terms of actual loss in the industry today from reps. Said simply reps are not today a "credit and default" protection for loan buyers except where the loans are not as represented. This will truly damage capital market efficiency to the detriment of homeowners.

A point not covered with respect to short term EPD or Premium refund provisions of six months or less is the markets use these provisions as a way to establish a "presumption of representation and warranty violation." The process us used to avoid

extensive cost associated with research, claim and counter claim on loans that go into default or prepay very quickly. By avoiding all this cost the industry has a standard structure that resolves many early loan performance issues that are inconsistent with a well underwritten and documented loan.

### *C. Premium Refund Clauses*

Clauses regarding the return of purchase premiums in the case of loan prepayment do not appear to belong in a discussion of a recourse regulation. Recourse, as defined by the current proposal, is "an arrangement in which a bank retains, in form or in substance, any risk of credit loss directly or indirectly associated with an asset it has transferred and sold that exceeds a pro rata share of the bank's claim on the asset". The potential refund of a purchase premium is not a credit-related event. It is more appropriately classified under interest rate risk in that falling interest rates will likely trigger payment under the clause, or operational risk in that a payoff transaction is already in process at the time a loan is being sold.

### *D. Loan Servicing Arrangements*

The proposal states that non-reimbursed advances for any one loan must be insignificant, which is later defined as less than 1% of the loan balance, in order for cash advances to not be considered a recourse transaction. We respectfully disagree with this proposal for a number of reasons.

First, assessing whether the loans in the servicing portfolio meet the 1-% limit is a significant burden. The proposal specifies that this limit must be satisfied for any one loan, not for the entire portfolio on average. Making this assessment would require a complex analysis of all the potential costs involved in the foreclosure process by jurisdiction and what each investor is contractually obligated to reimburse for hundreds of thousands of loans. Presumably, this analysis would need to be repeated on some regular basis.

With the passage of time, amortization of the balance will make the 1-% limit more stringent. Fixed costs that are not reimbursed by the investor will increase as a percentage of the diminishing loan balance. The impact of inflation on costs will have the same impact. As the loan becomes seasoned, possibly both of these effects will be occurring at a time when it is becoming less likely that the borrower will default and incur the costs.

Second, the 1-% limit is more stringent for small loans than large loans. This will have the impact of making small loans less desirable in the servicing portfolio, which is likely to have an adverse effect on the price of the loan. Since small loans are more often associated with underserved borrower populations, this proposal could make it more difficult for these populations to achieve homeownership. The variability of foreclosure costs by jurisdiction could have a similar discriminatory result geographically.

Finally, the servicing valuation process properly includes an assessment of the potential costs that could be incurred in the event of default and foreclosure. As costs increase, servicing values decrease resulting in an adjustment to capital. To then require additional capital for these "recourse" servicing arrangements would penalize the servicer twice.

For the reasons listed above and because servicing assets already carry the highest risk weight for risk-based capital purposes, we propose that servicing arrangements be treated as non-recourse.

## II. Conclusion

In conclusion, the Consumer Mortgage Coalition would like to reiterate its support for the application of a ratings-based approach to determining credit risk for purposes of determining regulatory capital. We applaud the part of the rule that permits a 20 percent risk weighting for private mortgage-backed securities that are rated in one of the top two risk categories, i.e., AA or AAA.

We respectfully request, however, that the agencies refine further the proposed regulation to address the concerns we have outlined above with regard to representations and warranties and premium refund clauses.

Finally, we urge the agencies to reconsider the proposed treatment of loan servicing arrangements, and treat servicing arrangements as non-recourse.

Thank you for your consideration of our views. If needed, the CMC would be very pleased to provide the agencies with any further information you may need in order to promulgate a final rule.

Sincerely,

Anne C. Canfield
Executive Director