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RE: OCC - Docket No. 00-06; FRB - Docket No. R-1055; OTS - Docket No. 2000-15
Risk-Based Capital Standards; Recourse and Direct Credit Substitutes

Ladies and Gentlemen:

The Mortgage Bankers Association of America appreciates the opportunity to comment on the Joint Notice of Proposed Rulemaking (the "proposed rule") published March 8, 2000 by the federal banking and thrift regulatory agencies (the "agencies") on the capital treatment of recourse transactions and direct credit substitutes. In general, MBA supports the proposed rule. Specifically, we support proposed changes to the current risk-based capital rules to: (1) align the treatment of recourse transactions and direct credit substitutes; (2) discontinue the distinction between "standard" and "nonstandard" representations and warranties as proposed earlier; (3) adopt a multi-level, ratings-based approach to assess capital requirements on recourse

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transactions, direct credit substitutes and senior and subordinated securities in asset securitizations. However, we have very significant concerns regarding the impact of the proposed rule to residential mortgage loans and mortgage servicing rights as explained below.

Representations and Warranties

We support the agencies' decision to focus on whether representations and warranties function as credit enhancements, as opposed to whether they are somehow standard or customary within the industry. Under the preamble to the proposed rule, representations and warranties are deemed to function as *credit enhancements* "where, typically, a banking organization agrees to protect purchasers or some other party from losses due to the default or non-performance of the obligor or insufficiency in the value of collateral," 65 ***Fed. Reg***. 12320, 12325 (March 8, 2000). The preamble then indicates that any representation and warranty that functions as a credit enhancement to protect asset purchasers or investors from credit risk shall be treated as recourse. Id. at 12325.

This contrasts with the agencies' proposed treatment of representations and warranties that entail *operational risk*, which are treated as nonrecourse transactions. The preamble to the proposed rule provides that operational risk is assumed when a banking organization makes certain factual warranties unrelated to ongoing performance or credit quality. Under the preamble, warranties that are deemed to create operational risk include, "warranties that assets have been underwritten or collateral appraised in conformity with identified standards, and warranties that provide for the return of assets in instances of incomplete documentation or fraud." *Id.* at 12326.

In our opinion, the change in focus away from consideration of what constitutes a "standard" representation and warranty is appropriate and will clarify the purpose and application of a final recourse rule. On the other hand, we believe warranties that act to reassure a buyer that an asset is what it is purported to be at the sale date should be treated as nonrecourse even if protection to the buyer extends for a short period after sale. For example, we believe the agencies should treat as nonrecourse any warranty regarding loan quality at the date of the loan sale and likelihood of borrower default (within 4 months following the loan sale date). These warranties are most similar to warranties that address the underwriting of loans in that they seek to reassure buyers about the product they are purchasing. Moreover, both types of warranties convey significant economic benefits to banking organizations, as explained below.

Collateral and Borrower Risk Representations and Warranties

As described above, the preamble to the proposed rule draws a distinction between warranties that create operational risk versus credit risk. The preamble also acknowledges that warranties impose varying amounts and types of operational risk on banking organizations. However, the preamble would treat as recourse warranties that give assurances "that no circumstances exist involving the loan collateral or borrower's credit standing that could cause the loan to become delinquent." Id. at 12326.

In our view, a warranty that provides assurances (i.e., "assurance warranties") regarding the loan collateral or borrower's credit standing on the sale date should be treated as imposing operational risk. Such treatment would be consistent with the distinction set forth in the preamble to the proposed rule between credit risk and operational risk. These assurance warranties function as cost saving alternatives to reinspecting each loan prior to transfer by the seller and/or investor. Moreover, the cost savings and market efficiencies provided by these warranties generally far exceed any risk of loss assumed by sellers. This is particularly true in the context of mortgage loans that are sold in substantial and continuous volumes between correspondent lenders and wholesale lenders, and between wholesale lenders and investors. It is also true in the context of transactions involving mortgage servicing rights, which often are sold in volumes of hundreds of thousands of underlying mortgage loans in a single transaction.

If these assurance warranties were not available, sellers would be forced to demand higher prices to cover the additional costs associated with reaffirming the status of each loan on the sale date, or to transfer responsibility for that function to the buyer in exchange for a lower price. By reassuring investors and expediting transfers at relatively insignificant risk to sellers, these warranties encourage a more efficient and competitive marketplace for loans and mortgage servicing rights with better overall returns for banking organizations. If assurance warranties regarding the loan collateral or borrower's credit standing on the sale date were required to be treated as recourse, the capital rules would significantly overcompensate for the economic risk imposed and would place banking organizations at a serious competitive disadvantage with unregulated lenders by unnecessarily increasing their costs of doing business.

"Early-Default" Representations and Warranties

Under the proposed rule, "early-default" clauses would be treated as recourse. These clauses typically warrant that transferred loans will not become more than 30 days delinquent within a stated period after the sale date. The proposed rule would treat all "early-default" clauses as recourse, regardless of the period within which the seller is liable for repurchasing loans that become delinquent. The preamble to the rule indicates that once the stated period has expired, the transfer would no longer be treated as recourse. Id. at 12326.

As explained above, we believe warranties that act to reassure buyers about the condition of the loan on the sale date involve the retention primarily of operational risk and should be treated as nonrecourse transactions. We believe "early-default" clauses that provide for repurchases of loans or mortgage servicing rights within a reasonably short period after the sale date are in substance warranties that impose operational risk since they are designed to provide assurances about the condition of a loan at the sale date (as opposed to guaranteeing credit performance of a borrower). In our estimation, up to 4 months after the sale date would constitute a reasonably short period and would be consistent with an assertion that the warranty is primarily of an operational, as opposed to a credit, nature. This is because a loan that becomes delinquent within four months of the sale date was very possibly delinquent (or showing signs of becoming delinquent) on the sale date.

The preamble to the proposed rule suggests that concerns about the treatment of early-default clauses can be addressed by contract provisions that provide assurances about stated underwriting standards or, alternatively, that cap the amount of losses a seller is liable for. Because most standard contract provisions already provide assurances about underwriting standards, we have considered the suggestion that contracts be amended to cap the amount of losses a seller is liable for. In our view, this suggestion would have little, if any, effect on the safety and soundness of the industry. While contractual caps might provide additional assurances to regulators, they would also decrease industry profit margins. This is because buyers will demand a discount as compensation for the cap that would likely be greater than any loss the banking organization would incur under an early-default provision with a short window.

For these reasons, we recommend that "early-default" clauses with windows extending up to 4 months be treated as imposing operational risk, as opposed to recourse risk. Such an exception would be reasonable given that such clauses are a cost effective means of facilitating continuous sales of large volumes of mortgage loans and mortgage servicing rights. Without these provisions, sellers would have to accept lower prices for their products for a very limited actual impact on the industry's safety and soundness.

Other "Early-Default" Representations and Warranties

Moreover, we also question the appropriateness of treating as recourse early-default clauses that extend beyond 4 months, for as long as up to one year, in contracts for sales of mortgage loans and mortgage servicing rights. We believe these provisions serve an important purpose in facilitating sales by reassuring buyers about relatively minor borrower credit risks in circumstances involving continuous and substantial volumes of sales of similar assets. These clauses are driven by economy of scale considerations and are in most circumstances a cost effective trade-off given the higher price that transactions involving such clauses command. In our view, the same rule that applies to sales of singular assets, or assets sold infrequently or in packages of a few assets, should not be applied to transactions involving the very large volumes that occur in the mortgage banking industry.

Environmental Representations and Warranties

The preamble to the proposed rule contains language implying that a warranty made by a banking organization that a residential property is free of environmental hazards would be considered recourse if the property has not been subject to environmental assessment. Specifically, the preamble states, "A warranty that asset collateral is free of environmental hazards may present acceptable operational risk for certain types of properties that have been subject to environmental assessment, depending on the circumstances." Id. at 12326. Because "types of properties" is not defined, our members are concerned that the proposed rule could result in recourse treatment for sales of residential mortgage loans and mortgage servicing rights unless the underlying property has been subject to environmental assessment.

We strongly recommend that the proposed rule, or at least the preamble, be amended to explicitly state that individual single-family (1-4 units) residential properties are excluded from any environmental assessment requirement. Environmental assessments are neither economically feasible -- nor otherwise needed - for individual residential properties. Therefore, it would be highly inappropriate for the preamble to the rule to imply that such assessments may be required for residential properties. Otherwise, the rule would put banking organizations at a serious disadvantage vis a vis unregulated institutions, since the cost of obtaining such assessments, where feasible, would be very expensive.

Environmental assessments are necessary for commercial, multifamily, and subdivision development lending because of the risk that the mortgagee and developers could become responsible for cleanup or cleanup costs under Superfund and other laws. The situation is different for individual single-family (1-4 units) residences. The U.S. Environmental Protection Agency's "Policy Toward Owners of Residential Property at Superfund Sites, OSWER Directive #9834.6, published July 3, 1991, narrows the liability of a residential owner. In that directive, EPA stated its policy that--

> in the exercise of its enforcement discretion, [it] will not take enforcement actions against an owner of residential real property to require such owner to take response actions or pay response costs, unless the residential homeowner's activities lead to a release or threat of release of hazardous substances, resulting in the taking of a response action at the site. This policy does not apply when an owner of residential property fails to cooperate with the Agency's response actions or with a state that is taking a response action under a cooperative agreement with EPA... This policy also does not apply where the owner of residential property fails to meet other CERCLA obligations, or uses the residential property in any manner inconsistent with residential use.

Presumably, the policy would apply to a mortgagee taking title to the property as REO, since the policy is directed at a particular kind of property. Because of the limited potential liability, it does not make sense for a lender to incur the expense of environmental assessments for single-family properties nor does it make sense to do environmental assessments simply to avoid capital requirements.

Based on the foregoing, we believe only reasonable operational risk would be presented if the following conditions, standard in the conforming conventional secondary market, are met:

- The lender obtains an environmental lien protection endorsement (ALTA Endorsement 8.1) for each loan originated or comparable coverage in states where standard ALTA forms of coverage are unavailable; and
- The lender obtains an appraisal report with no notation of any hazardous condition observed during the inspection of the subject property or any information the appraiser became aware of through the normal research involved in performing the appraisal.

The American Land Title Association's Form 8.1, Environmental Protection Endorsement, provides assurances that, as of the Date of Policy, no environmental lien has been filed against the mortgaged property. See Part IV, Sec. 105 of the Fannie Mae Selling Guide regarding the environmental lien protection endorsement and Part VII, Section 303 for appraisal rules for properties affected by environmental hazards.

The above comments are repeated from MBA's comment letter on the 1997 proposed rule. The current proposed rule does not respond to our previously expressed concerns, nor does it acknowledge distinctions between the environmental risks associated with single family residential properties versus other types of properties, such as multifamily and commercial properties. We are very concerned that without an explicit exclusion for residential properties, examiners and other regulatory agency personnel may conclude that transactions involving sales of residential mortgage loans and mortgage servicing rights should be treated as recourse unless environmental assessments are obtained.

Mortgage Servicing Cash Advances

The proposed rule would treat loan servicing arrangements as recourse or direct-credit substitutes if the servicer is responsible for losses associated with the loans being serviced. Servicer cash advances made to ensure an uninterrupted flow of payments to investors or to ensure timely collection of the mortgage loans are specifically excluded from treatment as recourse or direct-credit substitutes, provided the residential mortgage servicer is entitled to full reimbursement or, for any one residential mortgage loan, nonreimbursable advances are limited to "an insignificant amount of the outstanding principal on that loan." The preamble to the proposed rule indicates that for this purpose "an insignificant amount" would be no more than one percent of the outstanding principal on that loan. Id. at 12326. Our members strongly object on several grounds to a 1% benchmark for unreimbursable advances.

First, the preamble to the proposed rule implies that loan servicing contracts typically limit the amount of unreimbursed servicing advances to a specific amount or percentage of a loan's outstanding principal balance. However, standard Fannie Mae, Freddie Mac, and FHA servicing contracts only specify the costs that the servicer will be reimbursed (for example, all or a percentage of attorneys' fees will be reimbursed). As such, it is difficult to assess the extent to which a particular loan servicing arrangement may result in losses to the servicer above 1% without examining the terms of a servicing contract in combination with the particular characteristics and circumstances of an individual loan. This suggests that servicers would be required to determine whether losses related to servicing advances may exceed the 1% benchmark on *every loan* underlying their servicing rights portfolios. We believe a loan-by-loan review would be extremely burdensome and costly for servicers to administer.

Let us illustrate the complexity and variability of a loan-by-loan analysis. FNMA provides different reimbursements for foreclosure attorneys and trustees. In Mississippi, for example, the maximum reimbursable attorney's and notary's fee for a non-judicial foreclosure is $500 (these

fees vary by state and whether it is a judicial or non-judicial foreclosure). If a servicer is unable to retain an attorney or a notary for that price or unable to get special approval from Fannie Mae, the servicer would have to cover the amount exceeding the cap. As a further illustration, FHA reimburses servicers for one property inspection per month on vacant or abandoned properties. However, we are aware that some servicers are forced to conduct weekly inspections in Chicago, for example, in order to avoid very onerous fast track demolition and night watchman ordinances. These additional inspections are not reimbursable by FHA.

Furthermore, it is unclear *how often* mortgage servicers would be required to assess the possibility that they might incur losses over the 1% benchmark on individual loans underlying their servicing portfolios. For example, would servicers be required to make judgments about "possible" (as opposed to probable) unreimbursed advances over the 1% benchmark for each loan underlying a portfolio only at the inception of a loan servicing arrangement? Or, would servicers be required to make such judgments for all loans being serviced on a continuous basis (say, at each year- or quarter-end)? If judgments are required to be made on an ongoing basis, the amount of servicing that constitutes "recourse" for a given servicer and a given portfolio will continuously change over time.

Consider, for example, that the degree to which a servicer may experience unreimbursed losses on an individual loan will change as the unpaid principal balance ("UPB") of the loan declines. Thus, every loan that survives to maturity will at some point become recourse because servicing advances, however remote, will exceed the UPB of a loan. In addition, the proposed rule could require servicers to continue to reevaluate whether the servicing of an individual loan is recourse as fixed costs change (for example, foreclosure costs increase due to inflation). Thus, the amount of servicing that constitutes recourse for a given servicing portfolio could be a constantly changing amount.

A continuous assessment would increase servicers' administration costs for little, if any, gain in terms of safety and soundness. At a minimum, servicers would have to institute the necessary procedures and allocate the necessary personnel to perform the periodic task of judging the "possibility" that they will experience unreimbursed losses of more than 1% on the loans underlying their servicing portfolios. Given the thousands, and hundreds of thousands, of loans underlying most financial institutions' servicing portfolios, a continual reassessment of this nature would be burdensome for all servicers.

The proposed rule is unclear also with respect to the types of loans that should be taken into consideration by servicers when making judgments about the amount of possible unreimbursed advances exceeding 1%. Specifically, it is unclear whether the proposed rule would require a servicer's assessment to take into account possible unreimbursed costs on all types of loans, including FHA and VA loans sold to private investors (i.e., which are not collateral for GNMA securities). We are assuming that footnote 25 of the 1994 proposed regulations (59 Fed. Reg. 27116, 27123, n. 25 (May 25, 1994), which indicated that those proposed regulations did not address servicing rights associated with GNMA-guaranteed mortgage pools, also applies to all

FHA and VA servicing arrangements, since it would be logical to treat servicing of all government loans consistently, with the result that they all shall be excluded from any such assessment.

We also believe the proposed capital treatment of loan servicing arrangements would be inappropriate and excessive since probable future servicing losses are incorporated into sophisticated servicing valuation models today, with resulting adjustments in the reported values of the servicing rights. As such, the amount of an institution's capital would already be decreased by any decrease in the values of its servicing rights as a result of probable unreimbursed advances. The effect of the proposed capital treatment of loan servicing arrangements would be to penalize institutions that *properly* incorporate probable losses into the values of their servicing rights by, effectively, double counting the costs of unreimbursable advances for capital purposes.

The proposed rule could also have a discriminatory effect on loan pricing, since the 1% benchmark is easier to exceed on loans with lower outstanding balances. A servicer is more likely to experience unreimbursed advances over 1% on a $85,000 than a $225,000 loan. Thus, it is more likely that the proposed rule will require disproportionately higher capital on loans extended to low to moderate income borrowers. The proposed rule would become another incentive to increasing homeownership costs for that segment of the borrowing public.

For these reasons, we recommend that the agencies amend the proposed rule to treat all loan servicing arrangements as nonrecourse. We believe this treatment is warranted because: (1) a 1% benchmark would impose an extreme administrative burden on all residential mortgage servicers; (2) probable servicing losses are incorporated into the reported values of mortgage servicing rights today; and (3) mortgage servicing rights carry a 100% risk weighting and cannot exceed more than 100% of an institution's Tier 1 capital today. In light of these facts, it would be appropriate for the agencies to declare that the higher risk weighting for mortgage servicing rights (and Tier 1 limitation) is to account for unreimbursable advances. Alternatively, *at a minimum*, the agencies should clarify the rule to address the questions we have posed above and should increase the 1% benchmark to 5% to ease the burden of implementation.

Premium Refund Clauses

The agencies have invited comment on whether "premium refund" clauses should receive recourse treatment under any final rule. As described in the preamble, these clauses "require the seller to refund the premium paid by the investor for any loan that prepays within a stated period after the loan is transferred." *Id.* at 12326. Although it is unclear whether the "premium" to be refunded would include loan servicing premiums, or simply loan premiums, we believe these clauses are warranty provisions that give assurances to buyers about the quality of a loan at the sale date. In essence, they provide assurances to buyers that the loans being purchased are what they are purported to be by the seller, and that the seller is not aware of loans that are in some stage of being refinanced at the transfer date.

Furthermore, we believe recourse treatment for these clauses would be inappropriate because the amount of any premium paid on a specific loan (whether on the loan or for the servicing rights) is insignificant in relation to the UPB of the loan. Moreover, the number and amount of refunds the seller may be required to pay are likely to be insignificant in relation to the total UPB of loans sold and the total amount of premiums received on the loans. Therefore, recourse treatment of these clauses would vastly overcompensate for the risk involved.

Proposed Treatment for Rated Positions

We applaud the agencies' decision to move to a multi-level ratings-based approach to assess capital requirements on recourse obligations, direct credit substitutes, and senior and subordinated securities in asset securitizations based on their relative exposure to risk. This approach "uses credit ratings from the rating agencies and, to a limited extent, banking organization's internal risk ratings and other alternatives, to measure relative exposure to credit risk and to determine the associated risk-based capital requirement." *Id.* at 12327. We believe the agencies' decision to rely on objective market indicators as opposed to subjective groupings of different types of securities, recourse and direct credit substitutes is the best basis for establishing risk-based rules.

We also commend the agencies' decision to permit a banking organization with a qualifying internal risk rating system to use that system to apply the ratings-based approach to the organization's unrated direct credit substitutes in asset-backed commercial paper programs. We believe this decision will encourage the development of qualifying ratings systems within banking organizations to the overall benefit of the industry. Furthermore, we believe the decision will give "credit where credit is due" in recognition of those organizations that have devoted the resources to the development and maintenance of a qualifying ratings system.

Conclusion

In conclusion, the MBA generally supports the proposed rule. However, we believe the agencies' categorization as "recourse" of representations and warranties involving a loan's collateral or borrower's credit standing on the sale date is inappropriate given their similarity to representations and warranties that impose operational risk. We believe warranties that act to reassure buyers about the condition of a loan on the sale date are substantively like provisions that reassure buyers about standard underwriting provisions.

We also believe "early-default" clauses that provide for loan repurchases up to 4 months after the sale date should be treated as imposing operational risk since they act to reassure buyers about the condition of a loan on the sale date. Furthermore, we question recourse treatment for other "early-default" clauses in contracts for the sale of assets that occur in substantial volumes over a continuous period of time, including sales of mortgage loans and mortgage servicing rights within the mortgage banking industry. The same rule that applies to sales of singular assets, or

assets sold infrequently or in packages of a few assets, should not be applied to transactions involving the very large volumes that occur in the mortgage banking industry.

We also believe the agencies should clarify the proposed rule to expressly exclude residential properties from any language requiring properties that are not subject to environmental assessments to be treated as recourse. As explained, environmental assessments are neither economically feasible -- nor otherwise needed -- for individual residential properties.

Finally, we urge the agencies to reconsider the proposed treatment of loan servicing arrangements. As explained, the proposed treatment as recourse of unreimbursable loan servicing advances in excess of a 1% benchmark is very confusing and would be extremely burdensome to administer with little, if any, impact on safety and soundness. Consequently, we strongly recommend that the agencies delete this requirement from the proposed rule.

Again, the MBA greatly appreciates the opportunity to comment on this proposed rule. For further information about our comments, please contact Alison Utermohlen, Staff Representative to MBA's Financial Institutions Liaison Committee, at 202/557-2864.

Sincerely,

Robert M. O'Toole