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Office of the Comptroller of the Currency
Legislative and Regulatory Activities Division
400 7th Street SW, Suite 3E-218, Mail Stop 9W-11
Washington, DC 20219
Docket ID OCC–2017–0018; RIN 1557–AE10

Board of Governors of the Federal Reserve System
Ann E. Misback, Secretary
20th Street and Constitution Avenue NW
Washington, DC 20551
Docket No. R–1576; RIN 7100 AE-74

Federal Deposit Insurance Corporation
Robert E. Feldman, Executive Secretary
Attention: Comments/Legal ESS
550 17th Street NW
Washington, DC 20429
RIN 3064 AE59

Re: Simplifications to the Capital Rule Pursuant to the Economic Growth and Regulatory Paperwork Reduction Act of 1996

The Mortgage Bankers Association (MBA)[1] appreciates the opportunity to comment on the recent Notice of Proposed Rulemaking[2] issued by the Office of the Comptroller of the Currency, the Federal Deposit Insurance Corporation and the Board of Governors of the Federal Reserve (collectively "the agencies") proposing to reduce regulatory compliance burdens, particularly on community banking organizations, by simplifying certain aspects of the agencies' capital rules.

This letter focuses specifically on the proposed High Volatility Acquisition, Development or Construction (HVADC) rule and proposed changes to capital treatment of mortgage servicing assets (MSAs). Section I addresses our comments on the HVADC proposal and Section II addresses our comments relating to MSAs.

I. HIGH VOLATILITY ACQUISITION, DEVELOPMENT OR CONSTRUCTION (HVADC) PROPOSAL

The High Volatility Commercial Real Estate (HVCRE) rule applies to bank acquisition, development or construction (ADC) loans. The agencies propose to replace the HVCRE rule with a new High Volatility Acquisition, Development or Construction (HVADC) rule. Compared

[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 to 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 website: www.mba.org.

[2] Simplifications to the Capital Rule Pursuant to the Economic Growth and Regulatory Paperwork Reduction Act of 1996; 82 Fed. Reg. 49984 (Oct. 27, 2017) (hereinafter "NPR").

with the HVCRE rule, the HVADC rule would reduce the risk weight for ADC loans within its scope from 150 percent to 130 percent, but it also would increase the scope of loans subject to the higher risk weight. In addition, the proposal would provide some additional clarity as to which loans would and would not be subject to the higher risk weight.

A. Executive Summary

Since the agencies first released the final HVCRE rule in 2013 and the rule became effective in 2015, banks have sought clarification and modification of the rule. Banks want to be confident that they share a common understanding with regulators on how to interpret and apply the rule, and banks want flexibility to apply the rule's risk-sensitive incentives to a reasonable range of ADC lending contexts.

Therefore, while we appreciate this effort to change the HVCRE rule, and we share the agencies' goals of reducing regulatory burden, particularly for community banks, we believe the proposal represents a step backward on accomplishing that objective. For example,

- Despite some helpful new language, the rule still would not be clear enough to reasonably assure uniform interpretation of its terms;
- Removing the capital contribution exemption would eliminate the rule's risk sensitive incentives, would impose an unwarranted increase in capital requirements for lower-risk ADC loans, and would clearly not provide the flexibility banks seek; and
- The simultaneous application of inconsistent HVADC and HVCRE rules would create complexity, operational burdens and market impacts.

We believe, however, that the agencies could still address banks' concerns and meet the agencies' goals within the scope of this rulemaking. They could do so by further clarifying the definition of ADC loan; retaining and modifying the capital contribution exemption; and designing and implementing any final rule in a way that addresses operational burdens and market impacts. To reduce implementation risk, we recommend making changes by clarifying and modifying the HVCRE rule rather than by creating a new rule with broader scope and different substantive requirements. To mitigate remaining implementation risk, implementation should include grandfathering, with an option to apply the new rule to existing loans under the standardized approach and to apply the new rule under the advanced approach.

We offer our specific recommendations below in the sincere hope that the rule can be revised to meet what we believe to be our common objectives.

B. Background

The banking agencies issued the HVCRE rule as part of its Basel III implementation in 2013.[3] The stated intent of the rule included "strengthening the risk sensitivity" of the regulatory capital treatment for high-volatility commercial real estate.[4] The agencies selected the 150 percent risk weight for HVCRE based on their belief that banks should hold more capital against HVCRE exposures, based on supervisory experience.[5]

The rule became effective January 1, 2015. In response to numerous questions and concerns raised regarding how to apply the HVCRE rule by both MBA and its members, the agencies issued a set of joint FAQs in March 2015. The FAQs did not provide sufficient clarity or flexibility to the rule, and in some cases, raised more questions than it answered, so MBA and its members continued to seek guidance.

On a different path, the HVCRE rule was within the scope of a review the agencies conducted under the Economic Growth and Regulatory Paperwork Reduction Act (EGRPRA).[6] That review sought to identify outdated, unnecessary or unduly burdensome regulatory requirements.

The agencies reported the results of that review in the Federal Financial Institutions Examination Council, *Joint Report to Congress Economic Growth and Regulatory Paperwork Reduction Act*, in March 2017. The agencies' review included a focus on "*Simplifying the capital rules,"* with the stated objective of –

> *meaningfully reducing regulatory burden on community banking organizations while at the same time maintaining safety and soundness and the quality and quantity of regulatory capital in the banking system*[7]

The agencies stated that they were developing a proposal to simplify capital rules, including –

> *replacing the framework's complex treatment of high volatility commercial real estate (HVCRE) exposures with a more straightforward treatment for most acquisition, development, or construction (ADC) loans.*[8]

The table below illustrates the HVADC proposal that was an outgrowth of that process.

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[3] 78 Fed. Reg. 62018 (Oct. 11, 2013).
[4] 78 Fed. Reg. at 62011.
[5] See 78 Fed. Reg. at 62089 ("Supervisory experience has demonstrated that certain acquisition, development, and construction loans (which are a subset of commercial real estate exposures) present particular risks for which the agencies believe banking organizations should hold additional capital.").
[6] 12 U.S.C. § 3311.
[7] EGRPRA Report at 3.
[8] Id.

Summary comparison of HVCRE rule and proposed HVADC rule

	HVCRE rule (current)	HVADC rule (proposed)
Name	High Volatility Commercial Real Estate	High Volatility Acquisition, Development or Construction
Risk Weight	150%	130%
Definition of ADC Loan	Credit facility that "finances or has financed" real property ADC	Credit facility that "primarily finances or refinances" real property ADC
"Permanent" financing exemption	Excludes loans "converted to permanent financing"	Excludes "permanent loans" defined as "a prudently underwritten loan that has a clearly identified ongoing source of repayment sufficient to service amortizing principal and interest payments aside from the sale of the property. For purposes of this section, a permanent loan does not include a loan that finances or refinances a stabilization period or unsold lots or units of for-sale projects."
Property type exemptions	Excludes loans financing: • 1-4 family residential • Community development • Agricultural land	Excludes loans financing: • 1-4 family residential • Community development • Agricultural land
Capital contribution exemption	Excludes loans meeting prudential standards: • Appropriate supervisory LTV • 15% capital contribution • Restrictions on capital withdrawal	No comparable exemption

C. Comment on HVADC Rule

We comment below on the proposed HVADC rule, including the proposal to eliminate the capital contribution, the definition of ADC loan, the new “permanent loan exemption, risk weight, transition issues, property-type exemptions and agency interpretations of the rule.

1. Proposal to Eliminate the Capital Contribution Exemption

In its most significant departure from the current HVCRE rule, the proposed HVADC rule would <u>eliminate</u> the capital contribution exemption, to reduce complexity.

Proposed change to definition of ADC loan

	HVCRE rule (current)	**HVADC rule (proposed)**
Capital contribution exemption	Excludes loans meeting prudential standards: • Applicable supervisory LTV • 15% capital contribution • Restrictions on capital withdrawal	No comparable exemption

As described in the notice, the agencies considered various means to clarify or modify this exemption, but concluded that alternative approaches were just as complex as the current rule. As a result, they elected instead to eliminate the capital contribution exemption.[9]

As the agencies acknowledge, this change would broaden the scope of loans that would be subject to a higher risk weight. The agencies seek to temper the impact by reducing the higher risk weight from 150 percent to 130 percent. As a result:

- The risk weight for loans that otherwise qualify under the HVCRE rule’s capital contribution exemption would increase from 100 percent to 130 percent; and
- The risk weight for loans that do not now qualify for the HVCRE rule’s capital contribution exemption would decrease from 150 percent to 130 percent.

[9] NPR at 49988.

a. Retain the capital contribution exemption

We object to eliminating the capital contribution exemption for a variety of reasons, as we describe below.

i. Eliminating the exemption does not address banks' concerns

The higher risk weight under the HVCRE rule imposes a regulatory burden on ADC lending. Many bank ADC lenders of all sizes have structured ADC loans since 2015 to comply with the capital contribution exemption to obtain a lower 100 percent risk weight, as a way to reduce the regulatory burden of the HVCRE rule.

To further reduce regulatory burden, banks would like to see certain restrictions in the exemption eased to provide more flexibility in how they can structure ADC loans to comply with the exemption. Eliminating the capital contribution exemption, however, moves in the opposite direction, fully eliminating banks' ability to structure ADC loans to obtain a lower risk weight, and directly increasing the regulatory burden of higher risk weights.

The proposal re-frames complexity as a proxy for the regulatory burden and then eliminates the exemption to reduce complexity. Complexity, however, is not the problem. As is evident in supervisory guidance on the subject, ADC lending is inherently complex[10] and banks engaged in ADC lending recognize and accept that structuring transactions to comply with the capital contribution exemption will necessarily be complex. By focusing solely on complexity and then solving that artificial problem, the proposal fails to consider or address bankers' actual concerns. To address bank concerns, the starting point must be to assume that banks value the capital contribution exemption. The next step is to adjust provisions that are overly restrictive. Accordingly, we strongly recommend retaining the capital contribution exemption in any final rule, and adjusting its provisions as we recommend below.

ii. Eliminating the exemption creates new problems

Eliminating the capital contribution exemption also would undermine the objectives of reducing regulatory burden, reducing complexity and preserving risk sensitivity by creating a new set of problems.

Eliminating the capital contribution exemption would increase the risk weight on loans that would otherwise qualify for the capital contribution exemption by 30 percent (from 100 percent to 130 percent). The increased cost of capital would pose a substantial new regulatory burden on bank ADC lending (with no change in risk), and the fact that reducing the risk weight would make this a 30 percent increase rather than a 50 percent increase does change the conclusion that this is a substantial new regulatory burden.

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[10] See, e.g., *Comptroller's Handbook: Commercial Real Estate Lending,* 16-35 (Ver. 1.1, Jan. 27, 2017).

Because eliminating the exemption would make the scope of loans subject to a higher risk weight larger than the scope under the HVCRE rule, it also would increase complexity. Upon the effective date of the HVADC rule, standardized approach banks would apply the HVADC rule to new originations and would apply the HVCRE rule to loans originated prior to the effective date of the HVCRE rule. Advanced approach banks would apply the HVCRE to new and existing loans under the advanced approach, and would apply the HVADC and HVCRE rules under the standardized approach. This additional level of complexity, and the accompanying regulatory burden of compliance would vastly overwhelm any arguable positive impact that could result from the rule having one less provision.[11]

Eliminating the exemption would also reduce the risk sensitivity of capital requirements for ADC lending. One of the agencies' core purposes when implementing Basel III was to increase the risk-sensitivity of regulatory capital requirements,[12] including specifically "strengthening the risk sensitivity of the regulatory capital treatment for … high-volatility commercial real estate."[13] Significantly, this risk sensitivity creates incentives to reduce risk by meeting more stringent LTV, capital contribution and capital retention requirements in exchange for a lower risk weight, and borrowers seeking ADC financing from banks have an incentive to conform to those requirements to be able to benefit from lower-cost loans. Eliminating the capital contribution exemption would eliminate that risk sensitivity and would eliminate incentives affecting how banks conduct ADC lending. It also would reduce bank leverage negotiating with borrowers to meet more stringent LTV standards and contribute capital. As a result, the proposal would be a giant step backward on capital sensitivity.

In sum, we believe that eliminating the capital contribution exemption would not address current shortcomings and would cause substantial new problems. Therefore, any new rule should retain the capital contribution exemption with changes consistent with our recommendations below.

Recommendation: MBA recommends that the capital contribution exemption be retained, and modified consistent with our recommendations below.

b. Increase flexibility within the capital contribution exemption

To provide the necessary flexibility around structuring ADC loans to comply with the capital contribution exemption, the agencies should revise some provisions to make them less restrictive. We believe that the recommended modifications below would result in a more flexible rule that would retain appropriate risk-sensitivity.[14] Notably, we have developed the recommendations below with extensive input from bank members who have been on the front lines applying the HVCRE rule since it first became effective in 2015.

[11] We discuss this challenge in more detail in Implementation Challenges section below.
[12] See Basel III Notice of Final Rule, 78 Fed. Reg. 62018 (Oct. 11, 2013) (the term "risk sensitivity" occurs 18 times).
[13] NPR at 62022; see also NPR at 49985.
[14] We have no suggested clarifications or modification to the LTV requirement.

i. Limit mandatory restrictions on capital withdrawals to 15 percent minimum required contribution

To qualify for the capital contribution exemption, borrowers must contribute at least 15 percent of the real estate's "as completed" value of the real estate, and banks must contractually prohibit borrower withdrawals of (1) capital contributed by the borrower, and (2) capital "internally generated by the project," for the life of the loan.

We believe that any mandatory restriction on capital withdrawals should be limited to the 15 percent minimum required borrower contribution. Requiring banks to restrict withdrawals of all contributed capital for the life of the loan creates a disincentive for borrowers to reduce bank's risk on ADC lending by contributing more than the minimum 15 percent.

Limiting the restriction on withdrawals to 15 percent capital also would provide flexibility around withdrawals of internally generated funds. The current rule can effectively preclude banks from ADC lending where the borrowing entity requires at least some minimal ongoing returns on capital. The mandatory restriction on internally generated capital also adds an unnecessary additional layer of complexity to the application of the rule.

In sum, withdrawals above 15 percent capital should be permitted if supported by sound underwriting. Even with this additional flexibility, the 15 percent minimum borrower contribution requirement and a restriction on the withdrawal of that capital would continue to establish a reasonable floor on a borrower's level of skin in the game.

Recommendation: MBA recommends that mandatory contractual limitations on withdrawals be limited to the 15 percent minimum capital contribution, so that withdrawals above the 15 percent minimum would be permitted if supported by sound underwriting.

ii. Recognize current appraised value of contributed land for purposes of the minimum 15 percent capital contribution requirement

The current HVCRE rule limits the capital contributions that count toward the 15 minimum capital contribution to cash, unencumbered marketable assets or development expenses out-of-pocket. As for contributed land, an FAQ issued by the agencies states that banks may count only the cash used to purchase contributed land toward the minimum 15 percent contribution.[15]

[15] Regulatory Capital: Frequently Asked Questions; High Volatility Commercial Real Estate (HVCRE) Exposures (March 2015) (hereinafter "HVCRE FAQs") ("7. *If cash is used to buy land, and that land is subsequently contributed to a new development, can the land still count as contributed capital? Does the banking organization need to document when and how much the borrower paid for the land?* Yes. If cash is used to purchase land that is subsequently contributed to an ADC project, the cash used to buy the land can count toward the 15 percent contributed capital amount. This 15 percent requirement must be met before the banking organization advances funds. The definition of HVCRE excludes CRE projects in which the borrower has contributed capital to the project in the form of cash or unencumbered readily marketable assets (or has paid development expenses out-of-pocket) of at least 15 percent of the real estate's "as completed" value. (See definition in question 6.) Consistent with the preamble

We believe that banks should have flexibility to count the current value of contributed land toward the 15 percent capital, based on an appraisal that meets FIRREA appraisal standards. This change would result in equal treatment of contributed land newly purchased for cash and contributed appreciated land. Economically, the impacts of a contribution of land recently purchased for cash and appreciated land are identical. In both cases, the contributed land decreases the amount of financing required to acquire the land, reducing the risk of the loan. Moreover, the value of either parcel of land is solely in the form of the land itself. Therefore, in our view, banks should have flexibility to count the value of the land in these two cases equally toward the 15 percent capital contribution requirement.

We note also that the current treatment of appreciated land imposes a regulatory burden that can prevent banks from prudently financing desirable projects where, for example, a developer purchased a property at a time when its value was low and waited to develop it until conditions, e.g., zoning, other development or changes in government policies, increased its value. These are loans that banks could prudently underwrite and structure in ways that reduce risk consistent with the requirements of the capital contribution exemption, and may be projects that are beneficial to the communities in which they are located. Counting the appraised value of contributed land would better enable banks to finance such projects.

Recommendation: MBA recommends that the current appraised value of contributed land count toward the 15 percent minimum required borrower contribution.

iii. Clarify meaning of "as completed" value for purposes of the minimum 15 percent capital contribution requirement

The capital contribution exemption requires a minimum 15 percent capital contribution, measured against the real estate's "as completed" value. We suggest clarifying that the "as completed" value for these purposes is not intended to include the value that would be attributable to stabilization activities.[16]

While there is existing regulatory guidance on "as completed" value,[17] additional clarification is necessary to prevent borrowers from essentially being punished for increasing the expected value of the property at the time the project is completed. For example, a borrower may substantially prelease a building during construction. That would reduce ADC uncertainty, reducing the bank's risk on the loan. However, if the resulting "as completed" value includes both the value of the completed building and the value of preleasing, the "as completed" value would be higher. If the "as completed" value is higher, the borrower would be required to

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to the regulatory capital rule, cash used to purchase land is a form of borrower-contributed capital under the HVCRE definition. The banking organization should document the details pertaining to the amount of cash paid for the land.").

[16] We note neither HVCRE FAQ No. 6 nor the agencies' Interagency Appraisal and Evaluation Guidelines sufficiently clarify this distinction as it applies under the capital contribution exemption.

[17] See, e.g., Comptroller's Handbook, Commercial Real Estate Lending, App. C, 125-126 (defining "Prospective market value 'as-completed' and 'as-stabilized'").

contribute a higher amount of capital to reach the 15 percent threshold. Ironically, the required capital contribution would be greater where the risk to the bank has been reduced. This, of course, is an absurd result as a matter of risk. However, confusion about what "as completed" means in this context makes this absurdity play out in real ADC lending transactions.

Recommendation: MBA recommends clarifying that the "as completed value" for purposes of computing the 15 percent minimum contribution does not include the value of stabilization activity expected to be in place at the time of completion.

2. Revised Definition of ADC Loan

The agencies propose to clarify the definition of ADC loan by amending the definition of ADC loan to replace the language "credit facility that … finances or has financed …" with the language "credit facility that … primarily finances or refinances …."

Proposed change to definition of ADC loan

	HVCRE rule (current)	**HVADC rule (proposed)**
Definition of ADC Loan	Credit facility that "finances or has financed" real property ADC	Credit facility that "primarily finances or refinances" real property ADC

As interpreted in the notice, "primarily" means that more than 50 percent of the loan proceeds would be used for ADC purposes. The proposal would also provide some additional language to the definition of ADC loan detailing what is covered by the terms "acquisition," "development" or "construction."

Clarity is critical to reducing regulatory burden by giving banks confidence that they share a common understanding with regulators on how to interpret and apply the rule. We therefore support the addition of the term "primarily" to the definition. This change is a common sense clarification of the term "financing" under the HVCRE rule and should help address some of our bank members' concerns. For example, it should help clarify that loans that are not fundamentally ADC in nature are not subject to the higher risk weight simply because the project includes some element of construction. We also appreciate the additional clarity provided by expanding the descriptions of ADC activity.

a. Add collateral and source-of-repayment language to further clarify definition of ADC loan

While the addition of the term "primarily" and the expanded descriptions of ADC activity are helpful, the definition needs to be further refined to sufficiently reduce regulatory burden arising from uncertainty. Specifically, the rule should further define ADC loan to include only loans:

- Secured by real estate,
- That depend upon future income or sales proceeds from, or refinancing of, such real property for repayment.

Limiting the definition of ADC loans to loans secured by real estate would clarify the definition by harmonizing it with FFIEC call report instructions, which are familiar and well understood by banks and regulators. Call report instructions direct banks to report ADC-type loans secured by real estate as "Construction, land development, and other land loans," and to report similar loans that are not secured by real estate under "Commercial and industrial loans."[18]

A key element of what makes ADC project lending risk unique is that repayment depends largely on the successful completion of ADC projects. Therefore, explicitly identifying this project risk as an element of the definition of ADC loan would help brighten the line between the loans the rule is or is not intended to capture. This also would harmonize the definition of ADC loan with the new "permanent loan" exemption, which similarly addresses source-of-repayment risk to carve out loans not subject to ADC-related risk.[19]

Recommendation. MBA recommends adding that an ADC loan is a loan secured by real estate that depends upon future income or sales proceeds from, or refinancing of, such real property for repayment.

b. Clarify timing of use of proceeds test

The notice states that the term "primarily" means that more than 50 percent of the loan proceeds would be used for ADC purposes. While it seems reasonable to interpret this to mean that this would be a determination made <u>at origination</u>, we recommend clarifying the use of proceeds for purposes of the rule is made at origination. Doing so would enable banks to determine with certainty the capital treatment of a loan at inception, based on the facts and documentation of the transaction, and to rely on that treatment for the duration of the loan.

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[18] See FFIEC, *Instructions for Preparation of Consolidated Reports of Condition and Income (FFIEC 031 and, 041),* Schedule RC-C, part I, items 1.a and 4(6) (March 2017).

[19] The proposed "permanent loan" exemption would apply to a "prudently underwritten loan that has a clearly identified ongoing <u>source of repayment</u> sufficient to service amortizing principal and interest payments aside from the sale of the property" (emphasis added).

Recommendation. MBA recommends clarifying that primarily financing or refinancing based on the use of loan proceeds is determined at origination.

3. New "Permanent Loan" Exemption

The proposal would replace the current rule's exemptions for ADC loans that have been "converted to permanent financing" with a new "permanent loan" exemption.

Proposed change to definition of ADC loan

	HVCRE rule (current)	HVADC rule (proposed)
"Permanent" financing exemption	Excludes loans "converted to permanent financing" in accordance with the banking organization's normal lending terms[20]	Excludes "permanent loans" defined as "a prudently underwritten loan that has a clearly identified ongoing source of repayment sufficient to service amortizing principal and interest payments aside from the sale of the property. For purposes of this section, a permanent loan does not include a loan that finances or refinances a stabilization period or unsold lots or units of for-sale projects."

We support the addition of the permanent loan exemption. It is a common sense, actionable interpretation and clarification of the terminology "conversion" or "converted" to "permanent financing" in the HVCRE rule. As such, it should better enable banks to confidently exclude loans at origination that do not present ADC risks because of the nature of the source of funds for repayment, even where they may facially appear to have some ADC characteristics. This exemption should also serve as a clear and actionable off-ramp from higher risk where projects have matured and no longer pose ADC risk – clarifying that the off-ramp does not require a formal "conversion" to a new loan.

a. Remove the presumption that bridge loans are ineligible for the exemption

We support the permanent loan exemption – and believe that it should apply according to its terms. Therefore, we are troubled by regulatory text that would categorically make bridge loans ineligible for the permanent loan exemption – even if their source of repayment otherwise meets the definition of "permanent loan":

[20] See HVCRE FAQ No. 12.

> *A permanent loan does not include a loan that finances or refinances a stabilization period or unsold lots or units of for-sale projects*.

Based on commentary in the notice,[21] the basis of this provision may be an opinion on the factual likelihood that a bridge loan could meet the standard. In our view, an opinion on factual likelihood is not an appropriate basis for a binding legal presumption. Moreover, such a presumption is factually either unnecessary or inappropriate. The language is unnecessary if the source of repayment for a bridge loan can never satisfy the “permanent loan” source-of-repayment standard, and is inappropriate if it a bridge loan can meet that standard. Accordingly, we recommend removing that the additional language and commentary, so that the source-of-repayment standard in the permanent loan exemption would apply consistently across all categories of loans in accordance with its terms.

Recommendation: MBA recommends removing the final sentence of the definition of “permanent loan” and modifying any commentary related to bridge loans to clarify that the agencies are not excluding from the permanent loan exemption bridge loans that otherwise meet the requirements for that exemption.

4. Revised Scope and Risk weight

The agencies propose to reduce the risk weight for ADC loans that do not fit into any applicable requirement from 150 percent to 130 percent, to account for the removal of the capital contribution exemption.

Proposed change to risk weight and capital contribution exemption

	HVCRE rule (current)	**HVADC rule (proposed)**
Risk Weight	150%	130%
Capital contribution exemption	Excludes loans meeting prudential standards: • LTV • 15% capital contribution • Restrictions on capital withdrawal	No comparable exemption

While the proposal would nominally decrease the risk weight from 150 percent to 130 percent, by also eliminating the capital contribution exemption, it would effectively increase the risk

[21] See NPR at 49990 (“The agencies are … clarifying that bridge loans generally would not qualify as permanent loans as the property is not generating sufficient revenue to make amortizing principal and interest payments. The agencies believe financing for bridge loans poses greater credit risk than permanent loans, and, therefore, should be subject to a higher risk weight.”).

weight from 100 percent to 130 percent for loans otherwise eligible for that exemption. We believe that such effective increases in risk weight should be supported by evidence and analysis of relative risks, and we see such support.

Rather than providing evidence or analysis regarding relative risk, the notice describes a calibration exercise. It suggests that the 130 percent risk weight is intended to keep the aggregate amount of capital banks hold against ADC loans about the same as under the current HVCRE rule, to account for the broader scope of loans that would be subject to a higher risk weight, which is a side effect of eliminating the capital contribution exemption.[22]

In our view, the purpose of adjusting risk weights should be to calibrate relative risk at the bank level. Therefore, risk weights should not be adjusted to calibrate aggregate capital levels across the banking system. Accordingly, the proposal does not provide relevant support for an increase of the risk weight for any category of loan.

Recommendation: MBA recommends that the proposal not impose any effective increase in risk weight on any class of loans, including loans that would be eligible for the capital contribution exemption.

5. Implementation issues

Under the proposal, multiple and conflicting standards would apply upon the effective date of the HVADC rule. The HVADC rule would apply under the standardized approach for loans originated after the effective date of the HVADC rule. The HVCRE rule would continue to apply under the standardized approach for loans originated prior to the effective date, and the HVCRE rule would apply to both new and existing loans under the advanced approach.

Multiple capital standards for ADC loans on effective date of HVADC rule

	Existing loans	New loans
Standardized Approach	HVCRE	HVADC
Advanced Approach	HVCRE	HVCRE

[22] See NPR at 49990 ("The agencies believe the reduced risk weight for HVADC exposures … would not result in a significant change in the aggregate minimum capital required under the capital rule."); see also EGRPRA Report at 3 ("*Simplifying the capital rules.* With the goal of meaningfully reducing regulatory burden on community banking organizations while at the same time maintaining safety and soundness and the quality and quantity of regulatory capital in the banking system, the agencies are developing a proposal to simplify the generally applicable framework. Such amendments likely would include (1) replacing the framework's complex treatment of high volatility commercial real estate (HVCRE) exposures with a more straightforward treatment for most acquisition, development, or construction (ADC) loans; ….").

The burden of complying simultaneously with two different capital standards for ADC loans would create tremendous operational challenges for individual institutions. The existence of multiple standards also could have adverse impacts on loan syndication markets, which depend on being able to satisfy lending requirements across multiple lenders.

The root cause of this disruption is the choice to change the fundamental structure of the rule, and to do so in a way that increases the scope of loans covered by the higher risk weight. The agencies then ask whether prior loans should be grandfathered and whether the HVADC rule also should apply under the advanced approach. This is effectively asking banks to choose between bearing a new, more punitive capital requirement and taking on an implementation nightmare.[23]

To avoid this untenable choice, the agencies should minimize conflicts between a new rule and the current HVCRE rule to the extent feasible, for example, by ensuring that the scope of loans subject to a higher risk weight under the new rule is less than or equal to the scope under the HVCRE rule. This would substantially reduce the risk of transition disruptions and severe compliance burdens, and could result in a rule that could comfortably and readily be applied across all loans, new and existing, and across both standardized and advance approaches. Our recommendations to clarify the rule and ease the restrictiveness of certain provisions are all aimed at helping the agencies achieve that outcome.[24]

To mitigate any remaining implementation risk, implementation should include grandfathering, with an option to apply the new rule to existing loans under the standardized approach and to apply the new rule under the advanced approach. An indication of success in the rulemaking would be that all banks would want to opt to apply the new rule across all loans.

Recommendation: To reduce implementation risk, MBA recommends that the scope of loans subject to a higher risk weight under a new rule should be less than or equal to the scope under the HVCRE rule. To mitigate remaining implementation risk, implementation should include grandfathering, with an option to apply the new rule to existing loans under the standardized approach and to apply the new rule under the advanced approach.

[23] See Questions 7 and 8. NPR at 49991.
[24] We note that the Administrative Procedures Act exempts interpretive rules or rules that grant or recognize an exemption or relieve a restriction from prior-notice requirements that apply to rules that create new substantive requirements, implicitly recognizing the difference in transition risk. See 5 U.S.C. § 553(d).

6. Property-type exemptions

The agencies propose no substantial changes to the three property-type exemptions, and they do not appear to propose to narrow the scope of any of them.

Proposed treatment of property-type exemptions

	HVCRE rule (current)	HVADC rule (proposed)
Property type exemptions	Excludes loans financing: • 1-4 family residential • Community development • Agricultural land	Excludes loans financing: • 1-4 family residential • Community development • Agricultural land

We have two recommendations as to these exemptions. First, responding to commentary in the notice,[25] we recommend that condominiums be treated as 1-4 family residential in the same way that townhomes and row houses are treated. The property types are sufficiently similar that they should be treated the same under the rule.

Second, we recommend that the agencies clarify that the simplification of the language of the community development exemption was not intended to narrow the scope of that exemption.

Recommendation: MBA recommends treating condominiums as 1-4 family residential properties in the same way as townhomes/row houses, and clarifying that simplification of community development exemption was not intended to substantively alter the scope of the current exemption.

7. Agency interpretations

To the extent that the agencies determine that official interpretations would help banks and supervisors apply the rule consistently and accurately, we believe they should be issued by way of an iterative process. Interpretations will be effective in achieving that objective only if (1) they address the right questions and (2) if the target audiences understand the answers. An iterative process can obtain and respond to feedback to meet both of those requirements.

Recommendation: MBA recommends that official interpretations be developed using an iterative process that can help ensure that they address the right questions and that the answers are understood by the target audiences.

[25] NPR at 49989.

II. MORTGAGE SERVICING ASSETS (MSAs) PROPOSAL

Prior to the issuance of the proposal, the agencies issued a proposal that would pause full implementation of Basel III for certain banking organizations as it relates to treatment of MSAs. In providing feedback to the agencies, MBA noted support for the pause and stressed its importance as a necessary step to avoid a “cliff effect” of full implementation on January 1, 2018 while the agencies continue to review and work on simplifying the onerous Basel III MSA rules. But for this pause, many small banks would likely have further reduced or exited the mortgage servicing business, and this would have resulted in irreparable harm to those banks, and probable negative impacts to their customers as well.

A. MSA Overview

MBA continues to support the efforts that have been made by the agencies over the last few years to work with the financial services industry in order to understand the implications of the punitive treatment of MSAs under Basel III rules – the result of which was the issuance of this proposal to simplify the rules and reduce burdens for banks. However, although MBA appreciates and understands the objectives of the proposal, we believe that the proposal does not go far enough to ameliorate the punitive effects of the Basel III rules applicable to MSAs, and thus, we make the following recommendations:

- Increase the 25 percent Cap to 50 percent (net of related DTL);
- Reduce the Risk-Weighting from 250 percent to 130 percent, and
- Make the rules applicable to all banking organizations

B. Comment on MSA Rule

1. Increase the Proposed 25 Percent Cap to at least 50 Percent

Basel III, as previously adopted by the agencies, limits the value of MSAs that can be included in Common Equity Tier 1 (CET1) capital to 10 percent, as well as limit the aggregate amount of MSAs, temporary difference DTAs, and significant investments in the capital of unconsolidated financial institutions in the form of common stock that can be included in CET1 capital to 15 percent. As noted above, full implementation of this rule was set to commence on January 1, 2018, but has now been permanently suspended at 80 percent implementation by the Agencies. Based on consistent feedback and input from MBA and other stakeholders, the proposal will amend Basel III rules by increasing the 10 percent cap to 25 percent and eliminating the 15 percent aggregate cap.

We fully support eliminating the 15 percent aggregate cap in the proposal. However, while we appreciate the proposal’s attempt to reduce the punitive nature of the Basel III 10 percent cap by increasing it to 25 percent. However, we believe that the increase does not go far enough to address the harshness of the rule, and therefore, recommend that the cap be further increased to 50 percent. A higher cap will ensure that many banks continue to retain servicing and as a result, continue to service their retail customer base.

Mortgage servicing is a very important line of business for many banks, as it is for many independent mortgage banks (IMBs), particularly those banks that originate mortgages. In fact, mortgage loan origination and servicing are the primary businesses for many banks, especially community banks. The servicing function – collecting payments, the administration of impound accounts for taxes and insurance, as well as the extremely important functions of working with borrowers who encounter difficulties in meeting their obligations under the loan – is arguably the most important relationship a bank or IMB has with its customers. This relationship with customers plays a significant role in strengthening the relationships that banks and IMBs have with the communities they serve.

Current rules that severely restrict or shrink how much MSAs these institutions can include in capital is unduly burdensome and will necessarily limit their ability to continue to provide the high-quality mortgage servicing that is central to their business models and valued by their customers. The primary drivers of who gets market share in mortgage servicing should be performance, capacity and service, rather than excessively high capital standards on one segment of the industry.

MSAs are not widely used outside the United States, but in this country they play a very important role in the American housing finance system's ability to provide a 30-year fixed-rate mortgage, and the value of MSAs are vital to a servicer's ability to provide affordable mortgage credit to consumers. The punitive treatment of MSAs under the regulation undermines the value of servicing assets at all U.S. banks, with adverse impacts to the entire mortgage finance chain. This unnecessarily punitive treatment of MSAs has transformed them into one of the most capital-intensive asset classes in the entire Basel III framework, despite the lack of any linkage between banks with MSAs and the causes of the financial crisis that Basel III was intended to address.

On more than one occasion, the MBA has attempted to impress upon the Agencies that MSAs should not even have been addressed during the Basel III negotiation process, and therefore, should not have become subject to the extremely harsh Basel III rules in the first place. This is because, as noted in the report of the regulators to Congress on the MSA capital rules ("the Report"),[26] the U.S. volume and sophistication of MSAs market is unique and decidedly different from those of the other countries involved in the negotiation process. Furthermore, because

[26] According to the report, "In discussions with supervisory authorities from other countries, they noted that their supervised firms have negligible ratios of MSAs to CETI capital." The regulators further explained in the report that it was quite likely that these negligible amounts were attributable to U.S. operations of foreign banks or associated with acquisitions. Board of Governors of the Federal Reserve System, Federal Deposit Insurance Corporation, Offices of the Comptroller of the Currency, National Credit Union Administration, *Report to the Congress on the Effect of Capital Rules on Mortgage Servicing Assets*, 41 (June, 2016).

MSAs are quite different in terms of valuation and liquidity from the other intangibles assets with which they were lumped together for purposes of applying the capital rules, there is every reason to believe that MSAs did not get the necessary discussion around what the appropriate capital rules should be for such assets, especially in an international negotiation process. If all factors had been analyzed and considered – including the fact that many banks in the U.S. have a long and established history of originating and servicing mortgage loans and effectively managing the asset – we believe that such a punitive, and arbitrary, cap would not have been established for this asset in the first place under Basel III.

Granted, the increase of the cap to 25 percent in the proposal greatly reduces the draconian effect of the original rule for many banks, but it is still based on the erroneous and outdated premise that MSAs are extremely risky and difficult to value. In fact, in the Report, the regulators noted that "the high level of uncertainty regarding the ability of banking organizations to realize value from these assets, especially under adverse financial conditions" is justification for the punitive MSA capital rules. Even if that was the case many years ago, it has not been so for the last several years. MSAs are now better understood, better managed, and better controlled. MSAs are included in the Dodd Frank stress testing performed by banks. Many holders of the asset have a better understanding of the asset and engage in various effective activities – including hedging – to manage volatility and greatly reduce the inherent risk of the asset. The great strides that have been made over the last few years to better understand, control and manage MSAs have not only made the asset one with an extremely low risk level, but have also resulted in increasing the ability of banks to value MSAs, which has led to well-functioning markets for MSAs. As a matter of fact, even though the regulators raised a lot of questions and concerns in the Report about the riskiness and liquidity of MSAs, there was some acknowledgement in the Report that Servicers have developed a wide range of methods for valuing MSAs and that there is an active market for them.

Although it sometimes takes longer to sell MSAs than other earning assets, the lengthy process does not relate to lack of ability to value or price the asset or the safety and soundness issues related to the asset. Rather, it has to do with the processes that have been put in place to protect consumers and investors. For instance, the process includes the time that is needed get Ginnie Mae, Fannie Mae or Freddie Mac approval for the sale, as well as the regulatory regime that requires transferors to send letters to the consumer from both the transferor and the transferee alerting them to the change in servicers. Furthermore, the process includes buyer due diligence as well as physical and electronic transfers of files and information to minimize the impact to borrowers who are being transferred.

In light of the foregoing, we believe that the agencies could further simplify the rules by going back to pre-Basel III era where there was no cap at all. There is no question that MSAs are now better understood and managed, and provide a safe and sound asset for the mortgage industry, and thus, should not be subject to an arbitrary cap as is the case under Basel III. If the Agencies insist on a cap, we believe that a 50 percent cap would be more appropriate and eminently prudent.

Recommendation: MBA recommends raising the proposed cap on the value of MSAs that can be included in Common Equity Tier 1 (CET1) capital to at least 50 percent.

2. Reduce the Risk-Weighting from 250 Percent to no more than 130 Percent

There has not been any evidence that a bank failed due to ownership of MSAs. In fact, as is common knowledge, many banks failed because of their positions in unsecured commercial or unsecured consumer loans. It is therefore surprising and illogical that unsecured commercial and consumer loans are risk-weighted at 100 percent under Basel III, whereas MSAs are assigned a minimum risk weighting of 250 percent. We strongly recommend that the Agencies amend the risk weighting assigned to MSAs. Not only is there no evidence that MSAs are any riskier than consumer loans, there is also no evidence that MSAs were a major reason for the 2008-2009 financial crisis.

As stated previously, MSAs should not have been included in the Basel III Committee's discussion in the first place, since MSAs did not play a major role in the financial meltdown. Even if we were to agree that MSAs are not easy to value, there is no compelling evidence that proves that a large concentration of MSAs on a bank's balance sheet poses a threat to safety and soundness to justify such a punitive risk weighting. Imposing such a punitive risk weighting on the asset would have the effect of forcing small banks to sell their servicing portfolios and exit the servicing business – a result that we have often stated warned will harm community banks as well as the communities they serve.

MSAs generally provide a natural hedge to interest rate risk, because as interest rates rise, the value of MSAs generally increases with slower prepayment speeds and reduced new loan production. Interest rate risk is one of the most critical risks that banks face, and MSAs help many banks manage this risk by providing a natural hedge. Many banks that hold MSAs as a separate line of business hedge their MSAs, which effectively negates the volatility of the asset and significantly mitigates the risk to the bank of holding MSAs.

Current accounting rules that require banks to obtain regular valuations for MSAs has helped significantly to increase the ability of banks to value and price MSAs, which has enhanced the liquidity of the market for MSAs in comparison to that of many types of bank loans that are not subject to the same level of capital requirements.[27] This, coupled with the fact that many banks

[27] In fact, FASB ASC paragraph 860-50-50-2 sets forth increased required disclosures for servicing assets and liabilities. Regardless of whether taxpayer uses Fair Value or LOCOM method of accounting for MSAs, institutions must disclose: 1. Management's basis for determining the classes of servicing assets and liabilities. 2. A description of the risks inherent in the servicing assets and liabilities, and if applicable, the instruments used to mitigate the income statement effect of changes in fair value of the servicing assets and liabilities 3. The amount of contractually specified servicing fees, late fees, and ancillary fees earned for each period for which results are presented, including

manage the volatility of MSAs by hedging, makes a 250 percent risk weight excessively high for this asset. Moreover, the proposal assigns a risk weight of 130 percent for high volatility acquisition, development, or construction loans (HVADC) loans, which are arguably more risky than MSAs. While there is no indication of why the vastly varying risk weights were chosen for these assets, we do not believe that it makes sense for MSAs to be so severely treated compared to the more risky HVADC loans. Therefore, MBA strongly recommends that MSAs be assigned a risk weighting that is not more than 130 percent.

It is hard to understand a justification for a blanket and arbitrary 250 percent minimum risk weight for all MSAs and for all banks. First, there is no indication that the Agencies (or the rules) distinguish between institutions that use fair market value accounting and those who use the lower of cost or market (LOCOM) method of accounting for MSAs. A 250 percent risk weight for the LOCOM method banks would be a significant increase from the current 100 percent (pre-Basel III) risk weight for MSAs that are not deducted from capital. As the Agencies are aware, pre-Basel III capital requirements are that the asset is a 100 percent risk weighted asset for what is not deduced directly from capital resulting in a range of risk weighting from 100 percent to 215 percent.[28] Secondly, the agencies (and the rules) do not distinguish between MSAs associated with subprime and those associated with prime mortgages. It is conceivable that a 250 percent risk weighting would be appropriate for MSAs associated with subprime loans, as there is no question that those loans were major contributors to the financial crisis.

We suggest that the agencies give serious consideration to the foregoing discussion and analysis, with particular emphasis on the distinction that should be made between MSAs associated with subprime and MSAs associated with prime mortgages; as well the application of different accounting methods for MSAs that results in different effective risk weights for institutions. We believe that such consideration would provide support for our position that a blanket 250 percent risk weighting for MSAs is unduly punitive and unjustified; and therefore, the proposal be amended to assign to MSAs (other than MSAs associated with subprime loans) a risk weight of no more than 130 percent - the risk weight that is assigned under the proposed HVADC rule.[29]

Recommendation: MBA recommends reducing risk weight for MSAs from 250 percent to no more than 130 percent.

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a description of where each item is reported in the statement of income. 4. Quantitative and qualitative information about the assumptions used to estimate fair value (for example, discount rates, anticipated credit losses, and prepayment speeds).

[28] Under current capital rules, if an entity has elected prospective Fair Value Accounting for MSAs, a 10 percent haircut to the value is required (deducted from capital) and the remaining 90 percent of the MSAs are risk weighted at 100 percent, thus making the effective risk weighting 215 percent.

[29] The calculations under current law applicable to FV and LOCOM method institutions would continue to apply, which would result in a higher effective risk weight for FV method institutions

3. Make the Rules Applicable to All Banking Organizations

As previously stated, MBA supports the goals and objectives of the proposal with respect to capital rules – simplification and burden reduction. However, we do not believe that having different rules for banking organizations based on size will simplify the rules or reduce burdens. Rather, it will create complexities and unfairness, results that the proposal purports to eliminate. In fact, there is a growing consensus that asset size, in and of itself, is a poor proxy for a bank's complexity and risk profile. For example, FDIC Vice Chairman Thomas M. Hoenig has commented that "regulation should focus on the business model rather than arbitrary asset-size thresholds."[30] These comments echo those of other policymakers[31] including Federal Reserve Governor Jerome Powell[32] and then-Acting Comptroller of the Currency Keith A. Noreika.[33]

Moreover, as part of the Capital Assessment and Stress Testing information collected by the Federal Reserve, large banks are required to complete a specific MSA form (FR Y-14Q) as part of their quarterly reporting. This requirement provides useful data used by the Federal Reserve to assess the capital adequacy of large BHCs and IHCs using forward-looking projections of revenue and losses, to support supervisory stress test models, and continuous monitoring efforts, as well as to inform the Federal Reserve's operational decision making as it continues to implement the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010. Hence, there is no reason to exclude advanced approach banking organizations from the benefits of the relief from the punitive Basel III rules, since their MSA positions are regularly reported and monitored under the Dodd-Frank Act, and as such, any threats to safety and soundness of the institutions are regularly monitored. Therefore, MBA recommends that the final rule, which we hope will incorporate the two recommendations above, will be applicable to all banking organizations (advanced and non-advanced approach banks).

Recommendation: MBA recommends that the final rule, revised consistent with our recommendations above, will be applicable across both advanced and non-advance approach banks.

[30] Thomas M. Hoenig, *BankThink A bank's **activities**, not its assets, should decide regulatory status*, Am. Banker (Nov. 16, 2017) (emphasis added). *See also* Thomas M. Hoenig, Statement on the Senate Banking Committee passage of S. 2155, the Economic Growth, Regulatory Relief and Consumer Protection Act (Dec. 5, 2017).
[31] Testimony of former Chairman Barney Frank in a hearing before the Committee on Financial Services, U.S. House of Representatives, *Assessing the Impact of the Dodd-Frank Act Four Years Later* (July 23, 2014) (responding to questions from members of the Committee regarding whether a banking organization's systemic importance should be based solely on size).
[32] Testimony of Gov. Jerome Powell in a hearing before the Committee on Banking, Housing, and Urban Affairs, U.S. Senate, (Nov. 28, 2017).
[33] Remarks by Keith A. Noreika, Acting Comptroller of the Currency, at the Midsize Bank Coalition of America Chief Risk Officer Meeting (Oct. 5, 2017) (highlighting that arbitrary thresholds have adverse effects).

C. MSA Proposal Impacts

As noted above, MBA greatly appreciates and supports efforts to address concerns raised about the complexity of the capital rules and the punitive treatment of MSAs under Basel III. However, we believe that much more still needs to be done in this area. If the proposal is finalized as is, many banks will be forced to sell servicing, and some will most likely leave the business of originating and servicing mortgages entirely. This would have a negative effect on the availability and cost of mortgages to consumers, which is not a desired outcome. We believe that the market for MSAs should allow servicing to be transferred between capable and willing market participants, rather than forced transfers that are necessitated by unduly harsh capital rules that impact capable market participants differently. We strongly believe that the changes recommended above will reduce the harsh and punitive treatment of MSAs, as well as level the playing field for all servicers, regardless of size or structure.

The industry has repeatedly noted that Basel III sets a punitively high capital requirement that is excessive relative to the risk of the asset. If left unchanged, it will drive good bank servicers out of the business. This is bad for those banks, bad for investors and bad for consumers. Even if the industry could live with the increased 25 percent cap, the 250 percent risk weighting, which is unduly harsh and excessive, will drive many banks out of this line of business, resulting in the loss of a safe and sound earning asset for these banks.

The proposal's increase in the cap is a welcome indication of the Agencies' willingness to depart from the letter of the Basel Accord, while staying within the spirit of safe and sound capital treatment. We request the Agencies to rationalize the risk weighting of MSAs relative to much riskier assets by moving from 250 percent to 130 percent minimum risk weighting. On behalf of our membership, MBA appreciates the agencies' willingness to listen and to work for a solution and avoid any market disruption that would harm banks, non-banks and the consumers they serve. We respectfully request that the cap be increased to 50 percent (net of DTL) and the minimum risk weight be reduced to 130 percent.

III. CONCLUSION

MBA appreciates that the agencies are actively considering making changes to HCVRE rule and to the capital treatment of MSAs. We hope that the agencies will recognize that we provide these comments and recommendations in a spirit of trying to achieve the common objective of balancing appropriately tying capital to risk and reducing regulatory burden. Thank you for your consideration.

Should you have questions or wish to discuss these comments, please contact Steven O'Connor at soconnor@mba.org or 202-557-2867, or Thomas Kim at tkim@mba.org or 202-557-2745.

Sincerely,

David H. Stevens, CMB
President and Chief Executive Officer