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October 22, 2012

Mr. Robert deV. Frierson
Secretary, Board of Governors of the Federal Reserve System
20th St. and Constitution Avenue, N.W.
Washington, D.C. 20551
RE: Docket NoR-1430; RIN No. 7100 AD 87 and Docket NoR-1442; RIN No. 7100 AD 87

Mr. Robert E. Feldman
Executive Secretary
Attention; Comments/Legal ESS
Federal Deposit Insurance Corporation
550 17th Street, N.W.
Washington, D.C. 20429
RE: RIN 3064-AD 96 and RIN 3064-AD 95

Office of the Comptroller of the Currency
250 E Street, S.W., Mail Stop 1-5
Washington, D.C. 20219
RE: Docket ID OCC-2012-0009 and Docket ID OCC-2012-0008

Re: Standardized Approach for Risk Weighted Assets; Market Discipline and Disclosure Requirements

Re: Regulatory Capital, Implementation of Basel III, Minimum Regulatory Capital Ratios, Capital Adequacy, Transition Provisions, and Prompt Corrective Action

Dear Sir or Madam:

I am submitting this comment letter on behalf of the Council of Federal Home Loan Banks (Council). The Council appreciates the opportunity to comment on two notices of proposed remaking ("NPR" or "Proposals") that are designed to implement the Basel III capital framework and make other changes to U.S. capital rules. The first NPR, denominated "Standardized Approach," is the focus of the majority of our comments. We will indicate in the body of the letter the comments that are directed at the accompanying notice (Minimum Regulatory Capital Ratios, Capital Adequacy).

The Council appreciates the need to revisit the capital rules applicable to U.S. depository institutions and holding companies. As the financial crisis made clear, a strong capital buffer is a necessary safeguard for both individual institutions and our financial system as a whole. The Council agrees with the underlying goals of Basel III to strengthen the capital base of depository institutions and their holding companies; provide a buffer against systemic risk; and better correlate the required amount of capital and the risks presented by particular assets and financial activities. The concept of adjusting regulatory capital requirements to risk has been a key goal of our regulatory capital system since the implementation of the original Basel Accord in 1989. One of the most important reforms made by the Basel III revision is to require the use of more sensitive measures of risk when establishing minimum capital levels for the internationally active banking organizations that are subject to the so-called "advanced approach."

We are concerned, however, that the regulatory proposals, and in particular the provisions relating to the treatment of mortgage loans held by community-based institutions, fail to accurately align required capital and the credit risks presented by mortgage loans made since the financial crisis. We have a number of other concerns with the proposals, including the proposed treatment of private label mortgage-backed securities, other issues relating to securitization, mortgage servicing rights, commercial real estate lending, and the inclusion of Accumulated Other Comprehensive Income (AOCI) in the calculation of Tier 1 capital. All of these issues and others will be addressed in more detail below.

I. Mortgages Held In Portfolio Will Be Subject to Significantly Higher Capital Charges

Under current risk-based capital rules, a prudently underwritten mortgage loan, with a loan-to-value (LTV) of 90 percent or less, is assigned a risk weight of 50 percent. The current rules also consider private mortgage insurance as a substitute for part of the cash down payment. As a result, a borrower can combine a small down payment with private mortgage insurance in order to meet the 90 percent LTV standard. Likewise, by statute, both Fannie Mae and Freddie Mac consider the existence of private mortgage insurance as an alternative to meeting those companies' LTV requirements.[1]

Pursuant to the NPR, mortgages are divided into two categories, and then subdivided based on the LTV of the mortgage. Unlike the current rules, private mortgage insurance does not count when determining LTV. Therefore, a home buyer with a 10 percent cash down payment who obtains mortgage insurance on the loan will be considered as having a 90 percent LTV for regulatory capital purposes, notwithstanding the mortgage insurance protection.

Category 1 mortgages have lower capital charges than Category 2 loans. In order to be a Category 1 loan, the mortgage must be a first mortgage, may not exceed 30 years, and cannot have a balloon payment or negative amortization feature. The borrower's income must be verified. If it is an adjustable rate mortgage, any increase in the interest rate cannot exceed two percent per year, or six percent over the life of the loan. Most importantly, the creditor must make a reasonable determination that the borrower can repay the loan based on the maximum interest rate possible during the first five years of the obligation. These requirements are very

[1] Section 305(a) (2) of the Federal Home Loan Corporation Charter Act and Section 302(b) (2) (C) of the Federal National Mortgage Association Charter Act.

similar to the recently proposed definition of a "Qualified Mortgage," (QM) under section 1412 of the Dodd-Frank Act.[2] All other mortgage loans are Category 2 loans.

The risk-weight is then determined by looking at the LTV. For Category 1 loans, the following risk-weights apply:

LTV	Risk Weight
Equal to or less than 60%	35%
Greater than 60% but equal to or less than 80%	50%
Greater than 80% but equal to or less than 90%	75%
Greater than 90%	100%

For Category 2 loans the following risk weights apply:

LTV	Risk-Weight
Equal to or less than 80%	100%
Greater than 80% by equal to or less than 90%	150%
Over 90%	200%

II. Category 1 Mortgages Are Safe and Sound Loans

Historically, mortgage lending has been a safe and sound activity presenting very low credit risk to banking institutions. Until the recent period of high defaults and foreclosures following the initiation of the financial crisis, default rates on residential mortgages were exceedingly low. According to Federal Reserve Board data, from 1991 through 2005 the charge off rate on mortgage loans held by all commercial banks was never higher than .45 percent, and typically was much lower.[3] Delinquency rates on loans held by commercial banks during this period were likewise low, generally between two and three percent.[4] However, beginning in the early 2000s, lenders (primarily unregulated mortgage companies) began originating vast numbers of so-called Alt-A and subprime loans, often with one or more non-traditional terms such as: *no* down payment requirement; principal balances in excess of the market value of the home; low- or no-documentation requirement; very low initial rate for two or three years followed by a large jump in the applicable interest rate; deferred payments or interest-only payments, or negative amortization.[5] Ultimately, these loans began to default in record numbers.[6]

There is no question that the LTV ratio is an important factor in loan performance. A significant cash investment in a home purchase clearly lowers the risk of default and the loss given a default. However, the available evidence indicates that the proposed risk weights for

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[2] The major differences between the two requirements are that with the Qualified Mortgage points and fees are limited to three percent, and the mortgage underwriting must comply with any debt to income or residual income guidance that may later be issued by the prudential regulators. 76 Fed. Reg. 27390 (May 11, 2011).

[3] http://www.federalreserve.gov/releases/chargeoff/chgallnsa.htm

[4] Id.

[5] Board of Governors of the Federal Reserve System, *The Federal Reserve and the Financial Crisis* at 8-12 (2012).

[6] Although (as noted below) recent studies have shown that loans that used these nontraditional terms and non-traditional underwriting standards have experienced increased default rates, it should also be noted that investors have filed complaints asserting that mortgage companies and other lenders originating these non-traditional loans did not adhere to stated underwriting standards.

Category 1 mortgages with an LTV in excess of 80 percent are not warranted. Category 1 mortgages are, by definition, similar to the traditional mortgages that were fully documented and underwritten according to historical standards. And because regulated financial institutions will have to determine independently that the borrower has a reasonable "ability to repay" the loan, according to its terms, when the loan is made, it is likely that Category 1 mortgages will be subject to even more stringent underwriting than loans made before the subprime boom. In this regard it is important to note that the requirement to make this independent "ability to repay" determination is not presumed to have been met if the loan also meets the requirements for a qualified mortgage (QM). Thus a lender would have to make an "ability to repay" determination for all Category 1 loans, including qualified mortgages.[7]

In light of the characteristics of Category 1 mortgages it can be expected that these loans will have, at worst, the same performance characteristics of loans made in the early 2000s. Low down payment loans (loans with an LTV in excess of 80 percent) made up a substantial percentage of loans made before the subprime boom. For example, in the years 2001 - 2004, approximately 40 percent of the single-family loans purchased by the GSEs had LTVs in excess of 80 percent.[8] For first-time home buyers the percent of high LTV lending is greater. Low down payment mortgages constituted the *majority* of the financing for first-time home buyers in every year since 1990.[9]

Historically, these loans (including loans with LTVs in excess of 80 percent) performed well.[10] The delinquency rates for single- family mortgages purchased by the GSEs were less than 1 percent for every year between 1988 and 2005.[11] As noted earlier, the delinquency rates on residential mortgages held in portfolio by U.S. banks were also exceedingly low in the years prior to 2005. Based on the performance of mortgage loans at the time, the Basel Committee recommended a risk weight of 35 for residential mortgages under the Basel II standardized approach issued in 2004.[12] The Basel Committee has not amended this recommendation as part of the Basel III revisions. In 2011, the Center for Responsible Lending conducted a review of mortgage loan performance and concluded "badly structured loans and lack of underwriting, *not low down payments*, caused the foreclosure crisis."[13] A logistical regression analysis performed in 2011 by Genworth Financial Corporation using CoreLogic data for 2000-2008 found that the loan terms with the greatest correlation with performance were related to loan amortization (whether a loan is an interest- only loan or a negative amortization loan), and that the amount of the down payment (evaluated in 1% increments) was only the sixth most significant variable. Although we have not conducted our own analysis of this data, these studies conclude that

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[7] We question whether this represents good policy. A better approach would be to consider all QM loans as Category 1 and also subject to the presumption that the ability to repay test has been satisfied.

[8] Department of Housing and Urban Development, *Profiles of GSE Mortgage Purchases: 2001-04* at Table 10. Attached as Exhibit A.

[9] J. Duca, J.Muellbauer and A. Murphy, Federal Reserve Bank of Dallas, *Shifting Credit Standards and the Boom and Bust in U.S. House Prices: Time Series Evidence from the Past Three Decades* 31 (2012).

[10] According to economist Mark Zandi, "While there is no question that larger down payments correlate with better loan performance, low down payment mortgages that are well underwritten have historically experienced manageable default rates, even under significant economic or market stress." Mark Zandi, *Special Report: The Skinny on Skin in the Game*, Moody's Analytics (March 11, 2011).

[11] Office of Federal Housing Enterprise Oversight, *Annual Report to Congress,* Table 9 and 19 (June 15, 2006).

[12] Basel Committee on Bank Supervision, International Convergence on Capital Methods and Capital Standards (Basel II) (Rev. June 2006).

[13] Center for Responsible Lending, Comment Letter submitted to the federal banking agencies on Interagency Proposed Rule on Credit Risk Retention (August 1, 2011).

various non-traditional loan terms and weak underwriting have a stronger correlation with loan defaults than the amount of the down payment.

Category 1 mortgages are safe and sound loans that should have similar, if not better performance characteristics as the mortgages that were made before the subprime boom. These loans included millions of high LTV mortgages that performed well. Any change in the current capital rules should be based on the performance of well underwritten traditional mortgages, and should exclude mortgages that have non-traditional structures or followed nontraditional underwriting standards, such as without documentation of the borrower's resources. We believe that the performance data for high LTV pre-2002 loans demonstrate that the proposed risk weights for mortgages with LTV ratios in excess of 80 percent are too high. We urge the regulators to revisit the proposal in order to ensure that the regulatory capital charge is aligned with the economic risk of Category 1 loans that have LTV ratios in excess of 80 percent.

III. Effect of Other Laws and Regulations and Market Conditions

Another shortcoming in the proposed capital regulation is that it fails to recognize fully the impact of all of the statutory and regulatory changes that have been adopted or that are expected to be adopted shortly. The Dodd-Frank Act prohibits a creditor from making a mortgage loan without considering the ability of the borrower to repay.[14] And the Consumer Financial Protection Bureau (CFPB) is currently promulgating regulations to implement this requirement. These regulations will effectively require that lenders use very conservative mortgage underwriting standards,[15] or face potential liability for failure to consider adequately repayment ability when originating the loan. The Dodd-Frank Act also requires regulators to implement new rules relating to the securitization of mortgage loans.[16] These regulations will define a "qualified residential mortgage" which will likely become the standard for all new mortgages that are going to be placed into securitization vehicles.[17] These regulations will also require stringent loan underwriting. The CFPB is given broad powers to regulate mortgage originators, including restrictions on incentive compensation.[18] All of these new mandates will significantly raise the credit standards utilized in the extension of mortgage credit by regulated financial institutions. In establishing new capital rules, it is critically important to consider these new laws and regulations, both in terms of the quality of mortgages that will be originated going forward, and also in the cumulative impact these new rules will have on mortgage availability and cost. We are concerned that the cumulative effect of the proposed capital requirements coupled with the other new statutory and regulatory requirements could result in an adverse impact to mortgage availability and affordability.

Even without these new laws and regulations, the evidence from the market is quite clear. Unlike the experience of the last decade, in which qualifying for a mortgage loan was easy, it is currently very difficult to qualify for a mortgage loan. Banks and other lenders are demanding far higher credit quality than they did even before the early 2000s.[19] The problem for our

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[14] See Title XIV, Subtitle B of the Dodd-Frank Act.
[15] 76 Fed. Reg. 27390 (May 11, 2011).
[16] Section 941 of the Dodd-Frank Act.
[17] 76 Fed. Reg. 24090 (April 29, 2011).
[18] Semi-annual Report of the CFPB, *Significant Rules, Orders and Initiatives*, (July 2012).
[19] Joint Center for Housing Studies Harvard University, *The State of the Nation's Housing* 2012 at 19.

economy is not unsafe mortgage lending but the reluctance of private capital to enter the market. Higher capital requirements will only further reduce the availability of mortgage credit.

Concerns that mortgage underwriting standards may decline in the future are also misplaced. If there were ever an attempt to return to the home loan financing practices of the mid-2000s, the regulators have a broad array of new tools at their disposal to stop these practices.[20] In addition, the Financial Stability Oversight Council (FSOC) has the authority to determine that any financial practice presents risks to the U.S. financial system, and can request that the appropriate federal agency implement steps to prevent or curtail that activity.[21] This authority is not limited to large institutions, and thus the FSOC can use its influence to curtail risky practices conducted by any financial company without regard to asset size.

Regulatory tools, including the ability to raise underwriting standards immediately through regulatory guidance, should mitigate the concerns that the experience of the past decade will be repeated. Utilization of these regulatory tools to address risky lending practices is more effective than raising capital standards on all mortgage loans that have an LTV in excess of 80 percent, which would raise the cost of mortgage loans for all but the wealthiest segments of our country, and limit the ability of credit-worthy, first-time home buyers and minorities to obtain mortgage loans.[22]

IV. Balloon Payments

Another issue raised by the proposal is the blanket prohibition on balloon payment loans in Category 1. The Council believes there are balloon payment loans that are appropriate to a borrower's needs and repayment abilities and should be considered for Category 1 treatment with a risk weighting that addresses associated risk. Many of our member institutions, including community financial institution members, view balloon loans as an effective way to provide low cost mortgages to their customers. Many customers desire these loans because they know in advance that they will be moving within a prescribed number of years, or for other legitimate reasons. For financial institutions that have applied appropriate underwriting standards, particularly community- based lenders, the use of these products has not been problematic. We also note that from an asset-liability management perspective, community banks are more readily able to retain balloon mortgages on their balance sheet, reducing the need for securitization. Retention of the mortgages on balance sheet also provides a strong incentive for community banks to effectively and prudently underwrite and manage the risks in these loans.

Congress specifically recognized the importance of these loans in rural and agricultural communities and created an exception in the Dodd-Frank Act's qualified mortgage standard for

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[20] The federal banking agencies are empowered to issue enforceable real estate lending standards under section 304 of the Federal Deposit Insurance Corporation Improvement Act. The agencies are also authorized to increase required capital levels on an institution specific basis when they find that increased capital is required in light of the activities and assets of that institution. 12 U.S.C. § 3907(a) (2). See, e.g.. 12 C.F.R. § 3.9 ("The OCC is authorized … to establish such minimum capital requirements for a bank as the OCC, in its sole discretion, deems appropriate in light of the particular circumstances of that bank."

[21] Section 120 of the Dodd-Frank Act.

[22] Increasing the capital charge, and thus the cost, for mortgage loans with an LTV in excess of 80 percent will hurt all first-time home buyers that predominately rely on lower down payment mortgages. However, minorities as a group will be hardest hit. According to data from the American Housing Survey, 72 percent of African-American buyers and 63 percent of Hispanic buyers took out mortgages that were above 90 percent LTV in 2009.

balloon loans made by lenders in these communities.[23] We urge that any final capital rule treat well underwritten balloon loans as for Category 1 mortgages, especially if such loans are written by lenders in rural or agricultural areas.

V. Home Equity Lines of Credit and Second Liens

During the past decade, some borrowers avoided making any meaningful down payment towards the purchase of the home by using a second loan. These so-called "piggy back" loans increased the risk to the lender. However, home equity lines of credit (HELOC) and second liens that are not used for the purpose of funding down payments are an important source of financing for home improvement projects, medical expenses, educational payments, and paying off more expensive credit card debt. Under the proposal, all junior liens are considered Category 2 loans, unless the same party holds both the first and second exposure.[24]

The interest rate on home equity lines is typically indexed, but not capped. In addition, home equity lines of credit often allow the homeowner the option to make interest- only payments for an established period of time. Under the proposal the existence of either of these features would result in classifying a home equity line as a Category 2 loan. Thus, even if the HELOC is in a first lien position, or is held by the same lender who holds the first loan, the home equity line would be a Category 2 exposure.

As Category 2 loans, both HELOCs and second mortgages would have twice the capital charge as would be imposed on a first lien with a similar LTV. Even worse, if the second lien or HELOC does not qualify for Category 1 treatment, for example because it has a balloon feature or because its interest rate is not capped, and both loans are held by the same bank, the entire exposure (both the first loan and the second or HELOC) is treated as a Category 2 mortgage asset.

The proposal fails to distinguish between traditional variable rate loans and the much more troublesome teaser loans with an artificially low teaser rate for two or three years followed by a high jump in the interest rate resulting in "payment shock" to the borrower. Traditional variable rate loans, such as an underwritten 5/1 or 7/1 product, have been demonstrated to be both safe for the lender and useful to the consumer. Clearly there are many other well underwritten variable rate loans that should not be lumped into Category 2 because of the poor performance of the non-traditional 2/28 and 2/27 teaser products. Moreover, from an interest rate risk perspective, 5/1 or 7/1 mortgages, as examples, are likely to be more readily and effectively hedged by a financial institution than might be the case with a 30-year mortgage.

In short, the risk weight of home equity lines and other second mortgages that are made in conformance with traditional and prudent underwriting standards (including consideration of the combined first and second liens for LTV exposure purposes, and a determination that the borrower has the ability to repay both loans) should be adjusted to reflect the actual risk of the second loan or home equity line of credit. Simply doubling the risk weight from current rules does not appear to reflect the actual increase in risk.

VI. Commercial Real Estate

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[23] Section 1412 of the Dodd-Frank Act.

[24] Category 1 treatment is allowed if the same lender holds both the first lien and the second lien or HELOC, with no intervening liens. The lender combines the two exposures to determine the LTV of the combined loan. If both exposures meet the requirements for Category 1, the combined loan will qualify for Category 1 treatment. But if either loan does not meet the standards for Category 1, both loans are treated as Category 2 exposures.

The proposal would increase the risk weight of certain commercial real estate loans from 100 percent to 150 percent. The increased risk weight would apply to so-called High Volatility Commercial Real Estate (HVCRE) exposures: loans for the acquisition, development and construction of multi-family residential properties and commercial buildings. The higher risk weight would *not* apply to loans made for the development and construction of 1-4 family residential units.

Commercial real estate lending is a significant source of income for many of our community bank members. We understand that this can be a volatile asset, and that during the financial crisis many of these loans went bad. However, recent indications are that this market is recovering, underwriting standards have improved, and there is a significant need for credit in this sector. The regulators have numerous tools to prevent deterioration in underwriting standards, and the use of these tools would be a more effective means of addressing the potential risks in this type of asset than raising the capital charge for these loans without regard to the quality of the loan. Further, it makes little sense to have a higher capital charge for a secured loan (150 percent) than the capital charge that would result from making an unsecured loan to the same builder.

VII. Mortgage Servicing Rights

The term "mortgage servicing rights" (MSRs) refers to the right to service a mortgage by collecting monthly payments, managing the escrow, paying taxes and other fees, and dealing with delinquent loans and loans in foreclosure. These rights arise when a mortgage loan is sold but the servicing is retained by the loan originator or sold to a third party. For example, a community bank may want to sell a loan into a securitization pool, but retain the right to service the loan in its local community. Also, a small bank may wish to originate loans but sell the servicing to a larger institution that has the appropriate infrastructure to service the loan efficiently.

Under current rules, mortgage servicing rights may be treated as an asset of a bank in amounts up to 100 percent of the bank's Tier 1 capital. The value of the bank's MSRs must be reduced to 90 percent of fair market, and adjusted quarterly. The "minimum regulatory capital ratios, capital adequacy" proposal would reduce the amount of MSRs that may be included as a bank asset to 10 percent of the bank's common equity Tier 1 capital, and the remainder would have to be deducted from capital. Under the "standardized approach" NPR, the MSRs that are not deducted would have to be risk weighted at 250 percent. In essence, under the proposed treatment many banking organizations would likely leave this market, and the mortgage servicing function would move to nonbanking entities.

While mortgage servicing rights are sensitive to changes in interest rates, prepayment rates and foreclosure rates, they are nevertheless a valuable asset that has performed well prior to the financial crisis. These assets can be sold in a liquid market and can be used to support a bank's other activities. [25] Driving this asset out of the banking system will greatly decrease the

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[25] See, e.g. Testimony of FDIC Chair Sheila Bair, Hearing on Implementing the Dodd-Frank Act, Before the Senate Comm. On Banking, Housing and Urban Affairs, 111th Cong. 2d Sess. 67 (2010)(While the value of mortgage servicing rights can be volatile, they clearly have value); Testimony of Federal Reserve Board Tarullo, Hearing Before the Subcommittee on Security and International Trade of the Senate Comm. on Banking, Housing and Urban

number of companies able and willing to perform this activity, and thereby raise the cost of servicing for the public, and deprive regulated financial companies of a stream of revenue that can be used to support other lending activities. The net effect will be to increase the cost of mortgage loans.

Because MSRs gain value when interest rates increase, this asset acts as a natural hedge against interest rate risk. If MSRs are forced out of the banking system, banks will either have more exposure to the risks of increased interest rates, or will have to purchase swaps and other hedges at an increased cost to the institution, and ultimately to the public.

We are well aware that in recent times MSRs suffered significant declines in value due to the large number of delinquencies, defaults and foreclosures. All of these events raise the cost of servicing. In addition, when a loan is refinanced the servicing fee for that loan is terminated. However, the capital rules should be forward looking, and not based on the unique circumstances of the past few years. As previously noted, on a going forward basis home mortgages will be underwritten, and will likely perform, according to historical norms. In the 1990s, the regulatory agencies increased the amount of MSRs that could be counted as an asset from 50 percent to 100 percent of Tier 1 capital.[26] At that time the agencies expressed the view that the requirement to haircut this asset by 10 percent, and determine its fair market value on a quarterly basis, would provide sufficient safety to enable banks to hold MSRs in an amount of up to 100 percent of Tier 1 capital.

We recommend that the agencies' concerns with regard to MSRs focus on the quality of the loans associated with the servicing rights, and not lump all MSRs together. If the underlying loans are prudently underwritten (*i.e.*, if they meet the QM standards that will soon be released), the associated MSRs should be allowed to count as an asset for up to 100 percent of Tier 1 capital. If the underlying loan does not meet this standard, a more stringent limit on the associated MSRs may be appropriate.

VIII. Securitization Issues

Under the capital rules in effect today, mortgage-backed securities (MBS) that are issued or backed by an agency of the United States, such as GNMA, are given a zero-risk weight. MBS issued by a Government-Sponsored Enterprise, such as Fannie Mae or Freddie Mac are assigned a 20 percent risk weight. Private label MBS are assigned a risk-weight based on the credit rating of the position. For example, securities in the highest or next highest grade (AAA or AA) have a risk weight of 20 percent. Securities in the third highest grade (A) have a risk weight of 50 percent.

The proposal does not change the treatment of MBS that are issued or backed by a U.S. agency (zero-percent risk weight), or MBS that are issued or backed by Fannie Mae or Freddie Mac. However, the proposal makes significant changes in the treatment of private label MBS.

For private label securities the proposal does away with reliance on credit ratings,[27] and instead will require the investing bank to undertake its own due diligence of the credit risks

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Affairs, 111th Cong. 2d Sess. 16 (July 20, 2011)(Mortgage servicing rights, again, are not the same as an asset already on the balance sheet, but they are an expected stream of earning which have performed well in the past)

[26] 63 Fed. Reg. 42669 (Aug. 10, 1998).

[27] Under section 939A of the Dodd-Frank Act the regulatory agencies are required to end the use of credit ratings for regulatory purposes.

involved, and demonstrate to the bank's examiner a comprehensive understanding of the structure and risks of the security. The due diligence must include an analysis of the features of the securitization that could materially affect performance, including the cash flow waterfall, triggers, credit enhancements, and the specific definitions of default used in the securitization.

A bank would also be required to consider relevant information about the performance of the underlying securities, market data, price volatility, trading volume, liquidity support, percentage of loans that are 30, 60 and 90 days past due, loans in foreclosure, overall default rates, occupancy data, average LTV of the underlying loans, average credit scores of the borrowers, the extent of the geographic diversification of the loans and size, depth and concentration of the market for the securitization including bid-ask spreads. The bank's analysis must be conducted and documented prior to the purchase of the instrument. If the bank cannot demonstrate such a comprehensive understanding, it would be required to risk weight the exposure at 1,250 percent.

Based on the bank's analysis, the appropriate risk weight for the security would be determined using one of two prescribed models in the regulation.

With respect to banks selling mortgages into a securitization pool, the "minimum regulatory capital ratios, capital adequacy" NPR requires the selling bank to deduct from Tier 1 regulatory capital any non-cash gain on sale that would be recognized under generally accepted accounting principles, and apply a risk weight of 1,250 percent to any credit enhancing interest only securities generated by the securitization.

We agree with the proposal that the risk weight for mortgage backed securities issued or guaranteed by a U.S. agency and Government-Sponsored Entities should not be changed. However, we are concerned that the proposal inhibits private label securitization by making it very difficult, if not impossible, for community and smaller banks to purchase private label MBS. These institutions simply do not have the capacity to undertake the extensive analysis demanded by the proposal, and thus are likely to be frozen out of the market for these securities. The result will prevent these banks from acquiring higher yielding securities that will be backed by the stringently underwritten mortgages that are now being made.

We understand that under the Dodd-Frank Act the banking agencies can no longer link the risk weight for securities with the credit rating of those instruments. However, expecting small and community banks to engage in a sophisticated analysis of the products is not realistic and will have broader negative consequences for the housing markets. We therefore recommend that for small and community banks the requirement to engage in the extensive due diligence be waived and that a risk weight of 20 percent be assigned to private label MBS provided that all of the loans meet certain underwriting standards. In particular, we suggest that once the QM test is finalized, establishing the regulatory standard for a low risk mortgage, securities backed solely by such mortgages should be assigned a risk weight of 20 percent.

Further, we believe that the purchasing bank should be able to rely on a representation by the securitizer that all the loans qualify, and that the obligation of the purchasing bank be limited to a sampling of the loans. A small or community bank should be able to rely on an independent third party to conduct this sample. Finally, we recommend that the requirement in the "minimum regulatory capital ratios, capital adequacy" NPR that a bank selling loans into a securitization deduct from Tier 1 capital all non-cash gains on sale should be revisited. Rather

than a dollar for dollar deduction, the agencies should consider a supervisory approach in which the value of this asset could be adjusted if the examiner has reason to believe it is not valid.

IX. Repurchase Agreements

Under current rules, capital is required for any on-balance sheet exposure that arises from a repo-style transaction (that is, a repurchase agreement, reverse repurchase agreement, securities lending transaction, and securities borrowing transaction). For example, capital is required against the cash receivable that a banking organization generates when it borrows a security and posts cash collateral to obtain the security. The proposal would impose a capital charge on all repo-like transactions, regardless of whether the transaction generates an on-balance sheet exposure.

Under the NPR, a banking organization would be required to apply a 100 percent conversion factor to off-balance sheet repurchase agreements, securities lending or borrowing transactions, and other similar exposures. The off-balance sheet component of a repurchase agreement would equal the sum of the current market values of all positions the banking organization has sold subject to repurchase.

Repurchase agreements are a key part of the financial management of the Federal Home Loan Bank (FHLBank) system. The proposed rule will increase the capital charge for banks that sell securities to a FHLBank with the obligation to repurchase these securities at a later date. When the FHLBank is a counterparty, there is essentially no risk to the selling bank that the FHLBank will not be able to comply with its obligation to return the securities to the counterparty. We would urge the regulators to provide an exemption from this new capital requirement for off-balance sheet positions held as part of a repo transaction.

X. Swaps

FHLBanks, as well as other financial institutions holding interest rate sensitive assets, engage in derivative transactions to protect against changes in prevailing interest rates. The proposed rule requires banking organizations to hold capital with respect to such derivative agreements, with the amount of the capital charge dependent upon the counterparty, the collateral, and the remaining maturity on the contract. The proposal would not require a capital charge for derivatives cleared through a central clearinghouse. The FHLBanks use a wide variety of swap agreements to hedge the various types of funding that our member banks require, and therefore the use of a clearinghouse is not practicable for all swaps transactions. Further, when the FHLBank is a counterparty, there is essentially no credit risk to the counterparty. We believe that capital should not be charged when the counterparty is a FHLBank, even if a clearinghouse is not used.

XI. Inclusion of AOCI in Calculation of Tier 1 Capital

The "minimum regulatory capital ratios, capital adequacy" NPR would require that unrealized gains and losses on securities held as "available for sale" (AFS) would be reflected in a banking organization's capital account. The inclusion of these unrealized gains and losses creates the potential for several unintended consequences.

Community banks holding interest rate sensitive securities for asset-liability management or other sound business reasons, would see changes to their capital ratios based solely on interest

rate movements rather than changes from credit quality, without commensurate change in capital ratios resulting from movements in the market price for other assets classes or long term or structured liabilities.

Community banks would be incented to hold short term or floating rate securities to minimize the impact on their capital ratios from changes in interest rates. Although there could be beneficial reasons for holding longer term fixed rate assets such as municipal or mortgage securities, banks could be hesitant to do so realizing the long term, fixed rate nature of these investments would subject them to increased price sensitivity and impact on their Tier 1 capital.

Community banks would be incented to hold their securities in "held to maturity" category rather than available for sale to avoid the impact on their capital ratios. This would adversely affect a bank's ability to manage its balance sheet to respond to growing loan demand or changing economic fundamentals.

The inclusion of unrealized gains and losses in AFS securities would diminish the relevance and transparency of the Tier 1 capital measure due to institutions receiving inflated levels of Tier 1 capital from declining interest rates (and hence) rising market values of fixed rate, non callable securities. This change in capital could overstate the amount of Tier 1 capital if the subject bank had no intention of monetizing the gain on the securities; this could be the case in a scenario where economic activity is stagnant resulting in falling interest rates.

XII. Acquired Member Assets

We recognize that, as a conceptual matter, there may be some merit in the proposed rule's approach to RBC requirements for the mortgage programs that have been established by many of the FHLBanks whereby they acquire or fund conventional and government-insured residential mortgage loans originated and serviced by member institutions, known as Acquired Member Assets ("AMA") Programs. These programs operate under the names Mortgage Partnership Finance® ("MPF®") Program[28], first established in 1997, and the Mortgage Purchase Program ("MPP"), established in 2000. By using a unique risk-sharing structure, these programs allow participating members to retain a significant portion of the credit risk of the fixed-rate mortgages they originate when selling conventionally underwritten loans to the FHLBanks. Allocating the risks inherent in long term, fixed-rate mortgages in this manner results in a more efficient and lower cost mortgage financing benefitting American home buyers.

These programs are very popular with smaller community financial institutions because they provide an alternative to the traditional secondary market that can be difficult or prohibitively costly for many community lenders to access. Approximately 1,500 FHLBank member institutions, typically community banks, thrifts and credit unions, have used these programs to fund about $235 billion of mortgages that have helped home buyers in every state, including large numbers of low- and middle- income buyers, purchase a new home or lower the cost of their existing home through refinancing.

The structure of several MPF® products requires a participating member to provide a credit enhancement of a defined portion of a pool of residential mortgage loans that have been delivered to one of the FHLBanks. Even though the loans are held on the balance sheet of the FHLBank, the participating member must hold risk-based capital ("RBC") against its off-balance

[28] "Mortgage Partnership Finance" and "MPF" are registered trademarks of the Federal Home Loan Bank of Chicago.

sheet credit enhancement ("CE") obligation. As we understand the proposed rule, the amount of RBC required for participating members would be changed to more appropriately reflect the risk of potential losses related to the participating members' CE obligation.

Under the "standardized approach" described in the proposed rule, there are three possible definitional paths for a participating members' credit enhancement obligation in the AMA Programs: (1) "traditional securitization"; (2) "synthetic securitization"; and (3) "retail exposure." Based on our analysis, a member's credit enhancement required under the MPF® Program would likely fall into the "synthetic securitization" definition and resulting methodology.

The proposed rule eliminates the existing regulatory approach for RBC that has been in place since the MPF® Program was rolled out to members in 1997, replacing it with a much more conceptually appropriate, albeit complicated, formula. Further, the proposed rule would not grandfather existing MPF® pools under the current RBC rules.

Member credit support obligations in MPP programs are structured differently from those of MPF® products. Participating members' credit support obligations are limited to funding a risk based and FHLBank established Lender Risk Account ("LRA") from the proceeds of the sale of the mortgage loans (a purchase price hold-back) or a portion of the amount of interest paid by the borrower, and to providing supplemental mortgage insurance for some MPP products. Each MPP mortgage pool's LRA is used to reduce or offset credit losses suffered by the pool. No member is obligated to cover credit losses over and above the amount of funds in the LRA. Amounts remaining in the LRA after losses are returned to the participating member according to a predetermined release schedule. The participating member's exposure is therefore limited to the risk it will not receive all (or any) of the LRA, because the MPP FHLBank absorbs any losses in excess of the LRA. However, as in the case of the MPF® products, we understand that the proposed rule would not grandfather existing MPP pools under current RBC rules.

The Council recommends working toward a solution that implements the formula-based approach to determining the RBC requirement related to the member holding the CE obligation without requiring the risk weighting tied to Category 1 loans under the proposed rules. The formula-based approach could fit into the existing RBC framework that recognizes the safe and sound loans being sold into AMA Programs.

Modifying the proposed rule to more appropriately recognize the credit risk members accept by retaining a credit enhancement on high quality residential mortgages will encourage broader participation and the use of private capital to support the residential mortgage markets. However, the proposed rule's highly unfavorable treatment of mortgage servicing rights (as indicated in a previous section of this letter under the heading "VII. Mortgage Servicing Rights") would be very detrimental to the AMA programs, in which FHLBank member institutions generally retain servicing of the loans and thus maintain their relationship with their customers. Moreover, the rules should be simplified to more closely match the existing framework to reduce the risk that smaller community financial institutions might exit the mortgage origination market, which would further concentrate this market into the hands of a few, very large financial institutions and reduce choices for American consumers.

XIII. Disparate Competitive Impacts

One of the primary purposes of the Basel framework was to better align required capital and risk in order to reduce the competitive advantages that capital regulations could provide to different banking organizations. The same principle applies within a single country. When one segment of the financial services industry is required to hold capital that is in excess of the economic risk of its assets, the segments of the industry not burdened by these excessive capital requirements will have a market advantage. Thus it is critical that capital charges be closely aligned to the risk inherent in the portfolios and activities of the institutions subject to those charges.

As discussed above, we believe that the proposal will impose capital charges that are far in excess of the actual risks presented, especially for mortgages written since the financial crisis of 2008. As a result, non-regulated lenders will be able to gain market share at the expense of regulated banking institutions. Making this problem more severe, the bifurcated capital approach (standardized vs. advanced) creates the potential for significant disparate competitive impacts across the two approaches. The significant differences in capital requirements across the advanced and standardized approaches will almost certainly negatively impact community financial institutions as they compete with larger institutions in low credit risk portfolios like traditional mortgages.

XIV. Conclusion

The Council supports the efforts of the federal regulators to enhance regulatory capital requirements for insured depository institutions and their holding companies. However, overall we are unable to support these rules as proposed.

We believe that any increased risk weight must be appropriately aligned with the actual risk presented by the asset. High capital for non-traditional or poorly underwritten loans makes sense, and we support that policy. However, applying higher capital charges for traditional and prudently underwritten mortgages would be extremely counterproductive to our economy and to the American consumer. We therefore urge the regulators to evaluate carefully the need to increase the risk weight of Category 1 mortgages, and to take into account both current underwriting standards and the overlay of regulatory initiatives designed to assure prudent lending in the future.

The Council also urges the regulators to consider placing well underwritten balloon loans, made in rural or agricultural areas, into Category 1, as was done in the Dodd-Frank Act for QM loans.

The proposed increase in capital for high-volatility commercial real estate loans (HVCRE) is another area that should be reconsidered, in light of the changes in both regulatory oversight and the more recent performance of these loans. There is a great need for multi-family housing development, and increasing the capital requirements for these loans may have significant unintended consequences for this sector of the housing market.

Under the proposal, banking organizations would essentially be forced out of the market for mortgage servicing rights. We believe that this result is not in the public interest, and a better approach would be to link the treatment of mortgage servicing to the quality of the associated mortgage loans. For example, MSRs associated with loans meeting a QM standard should be afforded better treatment than other MSRs.

We also believe that the proposed treatment of mortgage securitization needs to be revised. Under the proposal, non-conforming loans would be particularly hard hit, since private label mortgage-backed securities would be significantly disadvantaged.

The Council believes that the higher capital required for reverse repurchase agreements and swap agreements that are not cleared should be revised to take into account situations where a FHLBank is a counterparty.

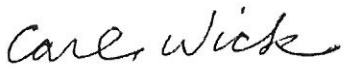
While as a conceptual matter there may be some merit in the proposed rule's approach to risk based capital requirements for the FHLBanks mortgage programs, known as Acquired Member Assets ("AMA") Programs, the proposed rule's highly unfavorable treatment of mortgage servicing rights would be very detrimental to the AMA programs. Moreover, the rule should be simplified to more closely match the existing framework to reduce the risk that smaller community financial institutions might exit the mortgage origination market, which would further concentrate this market into the hands of a few, very large financial institutions and reduce choices for American consumers.

The significant differences in capital requirements between the standardized and advanced approaches and the likely negative impact of this imbalance on community financial institutions also represent a significant concern. We suggest the standardized rule include a formal and scheduled recalibration of the standardized approach within the parallel reporting period of the advanced approach to achieve a greater degree of alignment and thereby eliminate significant competitive imbalances and other impacts detrimental to the safety and soundness of community financial institutions.

Finally, the proposed capital rule includes Accumulated Other Comprehensive Income (AOCI) in calculating Tier 1 capital. The inclusion of unrealized gains and losses on securities held as "available for sale" in determining Tier 1 capital has the potential to substantially increase the volatility of Tier 1 capital and distort the bank's regulatory capital ratios. Community banks holding interest rate sensitive securities for sound business purposes could see changes to their capital ratios based solely on interest rate changes rather than changes from credit quality.

We thank you again for the opportunity to comment on these proposals.

Sincerely,



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