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**Statement of the Shadow Financial Regulatory Committee**

on

**The FDIC's Proposed Regulation on  
Purchased Mortgage Servicing Rights**

February 26, 1990

The FDIC recently proposed a regulation that would limit the amount of purchased mortgage servicing rights that banks and savings institutions can recognize when calculating their regulatory capital. Under the regulation, the amount of servicing rights that would be recognized is limited to 25% of an institution's regulatory capital, with a five year phase-in provision. The FDIC has provided no evidence to indicate that servicing rights are a particularly risky asset.

Servicing rights are contracts to service mortgages for the owner in return for a fee. Many investors, such as pension funds and individuals, are now interested in acquiring mortgage-backed securities, but do not want to service the individual loans. A number of firms have developed expertise in this function, including commercial banks, savings and loans, and mortgage bankers. This appears to be a business in which economies of scale are significant, so that the efficient servicers handle a large volume of mortgages -- often more than they originate. Their willingness to buy servicing rights has created a liquid market in servicing, and enabled originators to earn a profit by selling servicing.

The mortgage servicing business has historically been a profitable one, though profits have been lower in recent years. Servicing is particularly attractive to thrift institutions because of the positive relationship between the value of mortgage servicing rights and the level of interest rates. As interest rates rise, mortgage prepayments decline, and so the value of mortgage servicing rights rise. Also, the escrow accounts that are part of the servicing relationship

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represent a low-cost source of funds to depository institutions (one that becomes more valuable if interest rates rise). As the Committee has noted earlier, the degree of an institution's exposure to interest rate risk does not depend upon having particular assets in its portfolio. Rather, it is determined by the relative interest sensitivity of the institution's assets and liabilities considered together.

Credit risk is not a significant problem in most mortgage servicing, since the risk remains with the owner of the mortgage. However, some mortgage servicing, including some servicing of VA loans, is done on a recourse basis, and does expose the servicer to risk of loss in case of default of the mortgage. The few institutions with a significant volume of recourse servicing, or with an undiversified VA mortgage portfolio, can be dealt with through the examination process. In any case, the accepted procedure for dealing with such risk is to calculate capital requirements as though the assets involved in such risk were actually on the balance sheet. Such treatment will tend to discourage banks from taking on risky recourse servicing without limiting their ability to engage in traditional mortgage servicing.

The FDIC appears to be concerned about the operational risks inherent in mortgage servicing. A breakdown in back-office operations can lead to losses by a mortgage servicer, but this potential problem that can easily be dealt with on a case-by-case basis. It is not appropriately addressed by a regulation applying to all mortgage servicers.

FIRREA imposed a severe and arbitrary restriction on purchase servicing rights by limiting the extent to which they can be included in regulatory capital to 90% of market value. Servicing rights do fluctuate in price, as do all bank and thrift assets. We believe that capital adequacy for all assets should be based on market values, and we support a high capital requirement. However, the proposed regulation involves an effective capital requirement on purchase servicing rights that may be many times that imposed on unsecured loans, and does so without any evidence of unusual risk associated with the mortgage servicing business.

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It is the Committee's policy that members abstain from participation on policy statements in which they have a direct personal or professional involvement in the matter that is the subject of the statement. Accordingly, Lawrence Connell abstained from participation in this statement.