

March 21, 2013

Mr. Arthur Lindo  
Senior Associate Director for Policy  
Division of Banking Supervision and Regulation  
Board of Governors of the Federal Reserve System  
20<sup>th</sup> Street and Constitution Avenue NW  
Washington, D. C. 20551

BY EMAIL

**RE: REGULATORY CAPITAL RULES: REGULATORY CAPITAL, IMPLEMENTATION OF  
BASEL III PROVISIONS AND PROMPT CORRECTIVE ACTION  
(herein referred to as "Proposed Rule")**

Dear Mr. Lindo:

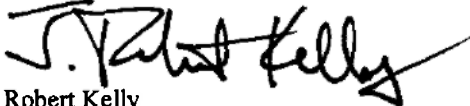
We appreciate this opportunity to express our views concerning the Proposed Rule noted above with respect to the impact on mortgage servicing rights, or mortgage servicing assets ("MSAs") as used in the Proposed Rule. While we also have concerns regarding other elements of the Proposed Rule and its companion proposals, including provisions addressing AOCI, risk weights and trust preferred securities, those issues have been well addressed in bank trade group comment letters, we limit the accompanying Memorandum of Views to the particular issues affecting MSAs.

Please do not hesitate to contact me should you wish to discuss or have any questions.

We are sending the Memorandum of Views to Ms. Anna Lee Hewko at your request.

Thank you for considering our views on what we believe to be an extremely important housing finance matter.

Best regards,



J. Robert Kelly  
Executive Vice President and Chief Risk Officer  
Arvest Bank

Cc:

Ms. Julie Stackhouse, Senior Vice President, Federal Reserve Bank of St. Louis  
Ms. Anna Lee Hewko, Assistant Director, Capital and Regulatory Policy, Division of Banking Supervision and Regulation, Board of Governors of the Federal Reserve System  
Ms. Candace Franks, Commissioner, Arkansas State Bank Department

**ARVEST BANK MEMORANDUM OF VIEWS**  
**ON**  
**REGULATORY CAPITAL RULES: REGULATORY CAPITAL, IMPLEMENTATION**  
**OF BASEL III PROVISIONS AND PROMPT CORRECTIVE ACTION**  
**(herein referred to as “Proposed Rule”)**

Arvest Bank (“Arvest”) is an Arkansas-chartered commercial bank and a member of the Federal Reserve Bank of St. Louis. Arvest is owned by Arvest Bank Group, Inc., itself a privately-owned bank holding company. Arvest has total consolidated assets of about \$13 billion and operates a traditional retail banking business through more than 240 branch locations in Arkansas, Kansas, Missouri and Oklahoma. In addition, Arvest, through its mortgage subsidiaries, engages in the business of servicing real estate first mortgage home loans for Arvest portfolio home loans, for home loans originated and sold with servicing retained and for home loans originated by Arvest and owned by others but which Arvest has purchased the right to service the loan.

We believe the capital levels that would be required by the Proposed Rule for Mortgage Servicing Assets (“MSAs”) are excessive. We have long internally allocated capital to the mortgage servicing business above traditional banks levels and above levels that would have been required for minimum levels required by the GSEs. However, the levels required by the Proposed Rule are at least 60% higher than we have conservatively assessed as the appropriate capital levels based on our experience over the years.

While we agree that banks should carry capital not only for the normal risk environment but also in sufficient levels to provide for the more unpredictable risks, the retention of excessive capital results is an inefficient use of capital resources. The disincentive resulting from requiring excessive capitalization can be expected to cause players in the servicing industry to re-assign capital to other more attractive opportunities. Even for banks holding mortgage servicing rights (referred to as mortgage servicing assets, or “MSAs” in the Proposed Rule) within the limit, it is reasonable to expect them to exit the home loan servicing business and put the capital to more economically productive use. It would appear to us that home loan servicing would either (a) further concentrate among the largest bank servicers who may have the opportunities of economy of scale necessary to partially offset the very large increase in capital costs resulting from the Proposed Rule or (b) exit the regulated banking system entirely. The added concentration of servicing among a few very large servicers reduces competition and likely lessens customer service levels to borrowers. We believe a vibrant servicing industry with operators across a broad spectrum of servicing volumes leads to increased competition and improved service levels to borrowers.

The Proposed Rule will also negatively affect the availability and cost of mortgage credit. This point was referenced in a Federal Reserve staff white paper on the housing market submitted to Congress by Chairman Bernanke on January 4, 2012. That paper (pages 6 and 7) stated that “...mortgage credit conditions have tightened dramatically from their pre-recession levels.” It went on to say, “This hesitancy on the part of lenders is due in part to concerns about the high cost of servicing...” Finally, the paper said, “...prospective capital treatment of mortgage servicing rights under Basel III may also be affecting the perceived costs and benefits of servicing operations.”

We agree with Chairman Bernanke and believe the Proposed Rule will lead to fewer banks being mortgage servicers and those who continue will have their growth effectively capped. It is difficult to imagine how that outcome is good for customers or overall mortgage finance. A servicing industry that has its best participants severely limited in size and with fewer participants

is likely to be less able to respond to the need to service home loans. This loss of industry capability will likely have consequences on home loan lending. This is no time in the economic cycle to implement harsh new capital rules that discourages capable servicers from investing further in the industry. Someone has to service mortgages and the loss of banks with long experience and extensive regulation has to eventually undermine the market's ability to handle customer demands for mortgage finance.

The banking regulators have rightly been concerned in recent years as to the exposure a bank has to the effect on capital of investments in MSAs. This concern is centered on MSAs being carried as an asset at a value based in part on a model and the concern that MSAs may not be liquid in a downturn. This Memorandum of Views addresses that issue and reports that the Arvest experience has been that the risk of model values concerns can, in large part, be mitigated with sound policy and procedures and ongoing frequent model validation. While liquidity concerns are always an area of interest, there is now, and was during the financial markets crisis, a viable market for MSAs. Arvest conducted 13 sales starting in early 2009 aggregating over \$33 billion in loan balance that in each case had interested buyers and in each case resulted in gains.

### **COMPARISON OF CAPITAL REQUIREMENTS - PROPOSED RULES VERSUS CURRENT RULES**

The Proposed Rule will result in much higher levels of capital requirements for investments in the mortgage servicing business.

The Current Rule generally allows banks to invest in MSAs up to 100% of Tier 1 Capital (the Current Rule allows 100% for all intangibles combined but a servicer could reach the 100% in some cases). As the MSA investment within the 100% limit is now risk-weighted at 100%, the capital requirement (i.e., minimum level to be well capitalized) is 8% (100% risk weight times 8% minimum capital level).

The Proposed Rule limits MSAs to 10% of Tier 1 Common Equity Capital and then subjects such allowed amount to a 250% risk weight (starting at 100% and rising to 250% over a phase-in period). As a result, the capital requirement becomes 20% (250% risk weight times 8%).

In both the Current Rule and the Proposed Rule, any MSAs in excess of the allowable limit must be capitalized dollar-for-dollar. We are not aware of any banks (or bank holding companies) that now hold MSAs in excess of the allowable limit, but that would not be the situation under the Proposed Rule.

The following table summarizes the results of our calculations of the change in capital requirements by examining numerous cases over a range of MSA investments ranging from 10% of Tier 1 Capital to 100%. The calculations results are summarized as follows:

MSA as % of Tier 1 Capital	Capital % Required – Current Rule	Capital % Required – Proposed Rule	Proposed Level to Current Level
5%	8%	20%	250%
10%	8%	20%	250%
15%	8%	47%	583%
20%	8%	60%	750%
25%	8%	68%	850%
30%	8%	73%	917%
50%	8%	84%	1050%
100%	8%	92%	1150%

{Note: These calculations do not take into account any changes from the Proposed Rule that may reduce Tier 1 Capital or raise the 8% capital levels. The above also does not reflect the separate and additional capital requirement on servicer advances that would have either a 100% risk weight or a 1250% risk weight, depending on the specifics of the advances, the latter being effectively dollar-for-dollar capital for the balances. Any of these occurrences would make the new capital requirement even higher.}

This analysis shows the draconian levels of increased capital that would be required to support an investment in MSAs. Effectively, the Proposed Rule incents banks to exit the home loan servicing business, even at lower levels of investment, as the 20% level of capital requirement makes earning a reasonable return on invested capital less likely. It seems logical that the servicing of home loans either (a) migrates to the very largest servicers who can achieve lower operating costs, (b) moves out of banking entirely into a less regulated arena or (c) subject to much higher fees, which eventually means higher cost of home loans to consumers. Of course, loss of a viable additional source of earnings to banks makes the banking industry itself more vulnerable through less diverse earnings sources.

For example, if a servicer currently earns an after-tax profit of 15% on its investment at the current 8% capital level, the return drops to only 6% at the new 20% proposed level. This level of return hardly encourages investors to provide capital. Furthermore, any servicing above the 10% limit would be subject to much higher capital levels, lowering returns on capital further. For all but the largest banks, a 10% limit may result in an uncompetitive business size, as a result of the significant economies of scale in the servicing business.

It is curious as to the reason for such an enormous increase in capital levels for a line of business that, to our knowledge, did not play a notable role in any bank failure during the recent financial market crisis and cycle of bank failures. We note that the Proposed Rule’s companion rule addressing risk weights leaves the risk weights for commercial real estate loans (“CRE”) at 100% or, if the CRE loan meets the definition of High Volatility CRE Credit Exposure (“HVCRE”), the risk weight increases to 150%. CRE loans played a prominent role in a very large portion of recent banks failures. A risk weight or 250% for MSAs does not square with the risk weights of CRE loans.

It should be noted that some banks may account for MSAs following fair value accounting (unrealized gains and losses flow through income each accounting period), and this can lead to creation of “non-cash capital” that is highly volatile. Many other banks use lower-of-cost or market accounting (“LOCOM”), that involves ongoing amortization of the MSA investment plus additional reductions for impairment recoverable only in future periods as market values of the MSAs rises and only to the extent prior impairment was previously expensed. Compared to fair value accounting, LOCOM is considerably more conservative in its recognition of gains, which

should work to temper the regulator's concern over the evaporation of capital due to declining MSA carrying values.

In fair value and LOCOM, both the Current Rule and Proposed Rule limit the MSA carrying value to 90% of the MSA market values for purposes of capital requirement calculations. With the sharp increase in capital requirements under the Proposed Rule, this additional haircut in the capital calculation appears to be unnecessary.

In summary, the Proposed Rule places extraordinary capital requirements on banks for investments in MSAs which appears out of sync with the level of any problems during the current cycle of banks failures, most certainly a highly stressed period. Indeed, the capital requirements of the Proposed Rule are so draconian that the clear message seems to be that banks should not be engaged in the mortgage servicing business at all.

### **CAPITAL AND RISKS**

Exhibit 1 contains a more detailed discussion of the relation of capital and risk with respect to investments in MSAs. The reader is encouraged to read this Exhibit before proceeding. Following is a summary of some of the key points from that Exhibit:

1. Based on more than 20 years of experience in mortgage servicing, Arvest believes the primary risks are operational, legal and market risks;
2. While credit risks are important, such risks are closely related to contractual obligations of the seller of servicing rights and of the servicer who buys the rights. In addition, the resulting assets consisting of servicer advances that often result from credit risks are subjected to additional capital requirements under both the Current Rule and the Proposed Rule as these advances are risk-weighted balance sheet line items (the Proposed Rule would use risk weights of either 100% or 1250% depending on the particulars of the advances). This results in additional capital requirement beyond the requirement directly for MSAs;
3. Operational risks are similar to other operational risks in banks that require sound policies and procedures, effective internal controls, requisite specialized knowledge and appropriate information systems;
4. Legal risks are very important, requiring legal expertise and industry knowledge in crafting contracts to fit the particular purchase of servicing rights, solid default management, and foreclosed property practices and effective policies and processes to ensure compliance with the many relevant laws, regulations and contractual obligations (such as GSE standards);
5. Market risk primarily involves the effect of interest rate risk ("IRR") and the ability to sell MSAs at a price at or above carrying values of the MSA. IRR is a standard banking risk subject to extensive scrutiny on an ongoing basis. The Arvest experience has been that MSAs have a reasonably active market and MSAs can be sold at prices that recover the MSA carrying value, especially where conservative accounting practice have been used in determining MSA carrying values. Arvest has sold servicing rights starting in early 2009, in the midst of the financial market crisis, and each time has active bids that resulted in gains;
6. The retention of servicing for loans originated and sold coupled with an active effort to help borrowers refinance when they desire results in the creation of new MSAs to replace the rights associate with refinanced loans. Refinance rates of more than 50% are possible which serves to mitigate much of the impact on MSAs of refinanced loans. In addition, the ability for a servicer to originate also allows capturing the benefits of the "natural

hedge” though origination of new loans that can more than offset any losses from servicing;

7. Servicing is not a one-size-fit all activity, and there can be many differences between servicers. For example, servicers may have different mixes of types of loans (ARM vs. fixed rate), maturities, geographic locales and underlying loan credit quality, all of which affect prepayment rates affecting MSA impairment. Also, use of fair value accounting to establish MSA carrying values normally would result in higher balances than LOCOM accounting.

While MSAs have their unique characteristics, the risk management process is well-known to banks. Sound accounting policies and practices coupled with ongoing model validation can effectively manage the risk of asset balances quickly declining due to model inadequacies in capturing market changes. Sales of MSAs on an ongoing basis is an effective way to both help validate model values and to show the marketability of the asset. Tax-exempt securities (and some MBS and CMO type securities) offer a similar risk in that often model values are used to support carrying values of the bonds as markets may be very thin. IRR management and determination of the Allowance for Loan and Lease Losses are also highly dependent on modeling and are subject to scrutiny similar to that applied to MSA models. The sound management of MSAs requires specialized knowledge, as does say C&I lending, but the methods and the tools to use in management are well established.

### **OBSERVATIONS FROM THE ARVEST EXPERIENCE**

Exhibit 2 contains a more in-depth description of the Arvest experience with MSAs and is intended to illustrate actual experiences of a bank servicer. The reader is encouraged to read the Exhibit to better understand those experiences. A summary of some of the more important observations follows:

1. Arvest has been involved in the mortgage lending business for decades and learned during the late 1970s and early 1980s the acute problems of mortgage lending in high interest rate periods (Arkansas then had a 10% usury rate which choked off all credit). This experience led to developing skills for a broader range of mortgage lending and ultimately led to expansion into home loan servicing as customers became dissatisfied with the servicing of their mortgages being transferred to one unknown party after another. Arvest studied the home loan servicing business extensively and entered the market in a notable way in the early 1990s through a purchase of a small thrift and in 1999 with the purchase of a community bank with a growing servicing subsidiary. Today, Arvest services over 250,000 home loans, of which about 75% are loans associated with Purchased Mortgage Servicing Rights (“PMSRs”);
2. Experience led Arvest to set an internal limit based on the parent company shareholder's equity to be invested in PMSRs that was far below the amount that would have been allowed yet above the standard well-capitalized bank capital requirements;
3. Arvest completed 13 sales transactions (involving over \$33 billion in loans balances) from June 2009 through February 2013, all of which resulted in net gains (i.e., net proceeds less carrying values of the MSAs sold was positive). Even the three sales in 2009, during one of the most adverse times of the financial markets crisis, resulted in a net gain;
4. Arvest has been an innovator in servicing through (a) developing an active loan modification process well before federal program became the norm (over 3,000 loan modifications were completed in 2007-2008 alone) and (b) working with Fannie Mae and

- Freddie Mac in designing programs to assist small originators in more easily accessing secondary home loan markets (Freddie GCX, Fannie SET and Fannie CAE);
5. Arvest has managed its risk with expanded use of “bifurcated” MSAs where some or all of the risks resulting from origination errors do not transfer;
  6. Over the period from 2008-2012 Arvest earned over \$25,600,000 in after-tax net income (about \$22,000,000 over the 2008-2010 period) from its purchased MSA servicing unit even after expensing \$208,000,000 in MSA amortization and impairment. While the originated MSA servicing unit lost about \$12.5 million over the five year period, the profits from the associated origination business more than offset those losses. Furthermore, the combined servicing business still earned over \$13 million without consideration of the origination business;
  7. Arvest refinances well over 50% of the loans serviced by its originated MSA servicing unit that refinance. This serves to offset much for the impact on MSAs of a refi cycle; and
  8. At no quarter end during the 2008-2012 period did the combined MSA book show a fair value to book value ratio of less than 112%. Even after reducing fair values for the 90% FDICIA cap used in the Current Rule capital calculation, the ratio was never below 101%.

The MSA sales over the 2009-2013 period appears to answer the regulator’s questions of ‘Can MSAs be sold in times of stress without loss?’ Certainly unpredictable levels of stress could occur that would adversely impact markets. However, the sales in 2009 show that in a highly stressful period there were buyers and at prices that made sense.

## **RECOMMENDATIONS**

We would be remiss to comment without providing suggestions as to how to revise the Proposed Rule. Our recommendations in this regard are as below:

1. Reduce the risk-weight on the MSAs allowable within the percentage limit. We believe the risk weight for the MSAs within the capital limitation should be no greater than 150% (note that the higher risk CRE loans would have a risk weight of 150% in the Proposed Rule and these were often the root cause of a very large number of bank failures). With the higher risk weights as compared to the Current Rule, the FDICIA 90% of fair value limit cap should be eliminated.
2. Increase the percentage limit of Tier 1 Capital. We believe the 10% of Tier 1 Common Equity Capital limit should be increased substantially to 50%. This is still a very substantial reduction from the current limit of 100%. Without a substantial increase in the allowable amount of MSAs, it would seem virtually assured that all but the largest players will exit the business because the risk-weighting above the limit is prohibitive and the amount below the limit is too small to provide sufficient economies of scale.
3. Grandfathering of existing levels of MSAs. If a limit less than 50% is implemented, then allow a grandfathering of the current MSA dollar levels at the same risk weight for MSAs within the new limit.
4. Exemption for non-SIFI banks. While we do not favor regulation by asset size, if the Proposed Rule is not materially changed, then apply the new rules to only banks that are designated as “systemically important financial institutions” (“SIFI”) under the Dodd Frank Act and provide for non-SIFI banks (generally those less than \$50 billion in assets) to have a MSA limit of 50% (instead of 10%). In either case, the risk weight for MSAs

should not exceed the 150% in Recommendation 1. At least in the case of SIFI banks, an independent determination has been made that certain banks are especially important with respect to systemic risk and should have less risk.

5. Reduced capital for lower risks. We prefer to have capital associated with the risk assumed, rather than with bank asset size. We believe our experience during the last five years of high stress evidences that the Proposed Rule goes well beyond what is needed as capital for MSAs. We recommend the US banking regulators study further how capital for MSAs can be better aligned based on the risks of the servicer's book of business and risk management practices. This might include consideration of servicing portfolio mix (ARM vs. fixed, whether or not eligible under the new CFPB QM Rule safe harbor, bifurcated MSAs, sensitivity to refinance risk due to falling interest rates and other relevant factors). While these sorts of differentiations are difficult, a matrix approach that relates accounting method (fair value vs. LOCOM), the portion bifurcated and the amount of interest sensitivity would seem practical. For example, a servicer using LOCOM accounting and that has more than 50% bifurcation and a low IRR sensitivity would qualify for a 50% limit while a servicer using fair value accounting, little bifurcation and high exposure to IRR would only qualify for a lower limit.
6. Reconsider risk weights on servicer advances. The idea behind the servicer advance risk weights (100% or 1250%) seems to be that the higher levels are needed the farther the servicer is from having priority rights on proceeds from sales of foreclosed properties or other assets. The 1250% risk weight results in a double counting of sorts as accounting rules require these assets to be reserved for much as loans. For example, a \$1,000 advance that qualifies for the 1250% risk weight would have a capital requirement of \$1,000 (the balance times 1250% times 8%). However, if the servicer had recorded a reserve of 20% so that the advance had a carrying value of \$800, the capital charge would be either (a) \$1,000 if computed on the gross advance or (b) \$800 if computed on the after reserve advance. In the first case, the capital would actually exceed the exposure. In the latter case, the servicer effectively has a 100% reserve even though the advance had been evaluated and a 20% reserve was needed. This situation is best addressed not by punitive capital requirements but by good accounting. Perhaps prudence would call for higher than 100% risk weights to reflect the variability in estimating needed reserves but that argues for a 200% type risk weight, not 1250%.

## **CONCLUSION**

Without major changes in the Proposed Rule, Arvest and others will likely exit or drastically scale back activities in home loan servicing. This would not just remove yet another line of business for the bank to diversify its revenues sources but would lessen the number of capable servicers available to the GSEs to accommodate mortgage housing finance needs. In Arvest's situation it may also mean having to scale back servicing of originated loans sold as well (i.e., for its core retail customers) which places them back in the "who is servicing my mortgage this month" world that customers clearly did not like. Importantly, as the Federal Reserve, itself, has noted in its white paper, the Proposed Rule will have a negative impact on the availability and cost of mortgages at this critical time in the economic recovery.

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**CAPITAL AND RISKS FOR INVESTMENTS IN MORTGAGE SERVICING ASSETS (“MSAs”)**

Banks should have capital sufficient both for normal risk environments but also to provide cushions for the more unpredictable risks that can be expected. The task is to assess the risk with a reasonable degree of accuracy and determine the proper amount of capital to maintain. Both the existing capital standards (“Current Rule”) and the Proposed Rule are based on a presumption that a well-capitalized bank operating soundly in an environment of normal risks needs 8% capital. Therefore, with 8% as the capital for normal risks, assets and activities less risky than “normal” would require less capital and those with more risk would have more capital.

Bank risk assessment guidance generally evaluates risk in categories of (a) credit, (b) market, (c) liquidity, (d) operational, (e) legal and (f) reputational. To justify large increases in capital requirements for MSAs, there must be some risk component that is substantially higher risk than the “norm” for a bank.

Based on more than 20 years of experience in servicing home loans, Arvest believes the primary risks involved in servicing home loans deserving special attention are market, operational and legal. The other risks each require proper management in the ordinary course of business. Credit risk is closely linked to legal risks as it relates to contractual obligations of the parties and requires a comfort level that counterparties can perform, if needed. However, this is similar to risk banks face frequently in lending with borrowers and guarantors and in selection of any number of different types of counterparties, all of which are normal business activities for banks. Also, it should be noted that one of the principal results of credit risk in home loan servicing is making servicer advances on loans, which is separately subjected in both the Current Rule and the Proposed Rule to additional capital requirements through risk-weights of either 100% or 1250%, depending on the specifics of the advances involved. Therefore, those risks are separately addressed in the capital calculations and not part of the MSA capital requirement.

**Market risk** involving MSAs is primarily (a) interest rate risk and (b) ability to sell at values equal to or in excess of carrying values. MSAs are interest-sensitive primarily due to the refinance risk of declining home loan rates and secondarily due to lower earnings on escrowed balances where the servicer is allowed to invest. This risk is at the heart of concern over the recoverability of the MSA investment without incurring losses that impair capital. Liquidity risk in the context of MSAs is closely related to market risk.

Market risk presents a type of risk that is certainly not foreign to banks. Interest-rate risk (“IRR”) management is central to sound bank management and is usually managed through an effective asset/liability management process. The basic IRR present is that of the refinancing of loans being serviced which renders the MSA worthless as there are no future revenues. While refinancing can occur in any interest rate environment, the risk is highest when mortgage rates are declining. In times of rising mortgage rates, MSAs tend to increase in value as borrowers retain the mortgage longer than normal meaning the MSA has a longer life and more lifetime revenues. An exceptional level of customer service coupled with a core banking relationship helps reduce the impact of refinancing when the borrower refinances the loan with the owner of the MSA. For

instance, it is not uncommon for 50% or more of borrowers to refinance a loan with the owner of the MSA who initially originated the loan which greatly reduces the net effect of the impairment of the MSA when the new MSA is recorded as an Originated MSA. This refinance benefit is related to but separate from the “natural hedge” that is present when a bank both originates and services home loans.

**Operational risk** arises from the various activities in servicing home loans including managing foreclosed real estate and involves such issues as policies, procedures, internal controls and information systems. Operational risk is mainly a matter of sound management that can mitigate risks through normal risk management techniques of appropriate policies and procedures, effective education and training of people involved, ongoing monitoring of results and a prompt feedback loop that leads to corrective actions, where needed. Operations are fundamental to servicing and the needed knowledge, tools and processes are well known.

**Legal risk** starts with the negotiation of the contractual terms when buying servicing rights and extends to the normal breadth of contracts, regulatory compliance and other laws. Contracts to purchase (or sell) servicing rights include risk mitigation provisions through representations and warranties of the parties.

A prime concern of bank regulators (and also of bank management and shareholders) with MSAs is the ability to recover the value carried on the balance sheet without diminishing capital. MSAs arise either through the origination of a mortgage loan for which the loan is sold but the right to service retained (i.e., Originated Mortgage Servicing Rights or “OMSRs”) or the right to service loans is purchased from a third party in a negotiated arm’s length transaction (Purchased Mortgage Servicing Rights or “PMSRs”). The Day 1 accounting for OMSRs follows extensive standards established by the Financial Accounting Standards Board which is lower-of-cost or market accounting while Day 1 balances for PMSRs are the purchase price. However, irrespective of whether OMSRs or PMSRs are involved, subsequent accounting (i.e., Day 2+) follows the same methods, in each case never to be allowed at an amount greater than 90% of market value for regulatory capital purposes. The risk of material misstatement of MSA carrying value is primarily mitigated by (a) the frequency of determining market values, especially by use of third party valuation specialists to validate fair value as calculated by bank’s internal model, (b) the regular reforming of “tranches” to reflect changes in make up of the MSA portfolio and (c) regular sales of MSAs to third parties to test the reasonableness of the model-generated estimates of market values. Such sales into the market should at least test the primary components of the MSA portfolio by including a representative sample of MSAs from the portfolio and by back testing sales results to the model to assess model assumptions. The application of accounting rules at the tranche level results in a more conservative carrying value as excess market value in one tranche is not available to offset a shortfall of market value in other tranches.

There are other factors that notably impact the risks associated with MSAs including whether or not the servicer assumes what is known as “origination risks” which directly affects exposure to “make whole payments” or whole loan repurchases (sometimes known as “buybacks”) when a loan defaults. The market values this risk directly in the pricing of MSAs with a lower price paid for MSAs that carry the risk. Servicing loans which were originated by the bank (or its subsidiary) generally has a higher likelihood of being refinanced by the bank than would purchased MSAs leading to new OMSRs to offset the lost MSAs. In addition, the type of loan (e.g., ARM vs. Fixed) can also lead to notably different prepayment rates which directly affect the MSA valuation. A single capital level without recognition of differing risks incents banks to

take on more risks and does nothing to reward those who reduce risks. This is counter to what the capital standards are intended to do.

Once a sound process is established and in place for the ongoing accounting for MSA carrying values, a further concern exists as to the accuracy of the underlying market valuations model to adjust to stressed scenarios. The process described above aimed at validating the model results, when done routinely throughout various economic cycles, coupled with the requisite back testing and analysis of model assumptions and with overall periodic model validation reviews by third party specialists is an effective way to provide a reasonable degree of assurance that the model will adjust as the economics on the ground change.

Most of the risks faced in owning MSAs are similar to many risks faced in a commercial banking and market risk which is of special concern is susceptible to sound management so that residual risk is reduced to acceptable levels.

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**OBSERVATIONS FROM THE ARVEST EXPERIENCE**

Arvest has been involved in the home lending business for decades, including servicing home loans held in portfolio before secondary markets became so prevalent. Arkansas banks were hampered for many years by a very limiting state usury law that caused lending in the state to essentially vanish in the late 1970s and early 1980s when interest rates soared. From this experience many Arkansas banks became skilled in the use of various types of adjustable rate mortgages and balloon mortgages to be able to provide credit locally. As mortgage rates began to decline and secondary markets for mortgages developed, borrowers wished to lock in the lower rates (as compared to the extremely high rates of the peak period) and Arvest began to develop skill in secondary market lending as well. Eventually bank customers who had obtained long-term fixed rates loans (and for which banks could not safely keep large volumes in portfolio due to the IRR mismatch) began to voice their concerns over having their mortgage handled by a bank or servicing agent with which they had no the relationship. In part, this borrower frustration arose from their loan being transferred multiple times, dealing with a servicer who had little knowledge of them and often would not make what the borrower considered reasonable exceptions and, in many cases, the inconvenience of not being able to make payments at their local bank.

Arvest studied the secondary marketing business for a considerable time in an effort to address these customer concerns. In the early 1990s, Arvest purchased a local thrift that had a rich history in home loan servicing, including experience in secondary market servicing. In the late 1990s, Arvest purchased a community bank in Little Rock that operated a small purchased MSA business under the direction of mortgage bankers with a long and highly successful history in mortgage banking at a larger regional bank. This acquisition built on the existing foundation built over the decades and allowed for an ongoing expansion of the servicing business. At December 31, 2012 Arvest through its subsidiaries service over 250,000 home loans of which about 75% is from MSAs purchased from third parties.

Mortgage servicing allowed Arvest to provide enhanced service to its core retail home loan borrowers by being able to make long-term fixed rate loans in volumes far beyond what the bank could keep in portfolio yet retain servicing so borrowers would be handled at their local branch. In addition, Arvest developed the needed experience, know how, processes, information systems and industry reputation to develop the purchased mortgage business into a viable line of business to diversify the revenues of the bank. The combination of these factors allows Arvest to engage in the servicing business safely at a fairly high level of investment.

In developing the business, Arvest recognized that while servicing helped to diversify risk and revenues, it could also become a concentration of risk of its own. To manage this risk, Arvest set an internal limit based on parent company shareholder's equity to be invested in PMSRs that was far below the 100% of Tier I capital that would have been allowed. This limit reflects Arvest's assessment of the risk faced and the bank's risk appetite with respect to achieving a more balanced source of recurring revenues. To test the validity of the model-produced market values, Arvest policy requires periodic sales of MSAs to compare market sales to model values used. In

order to stay within policy limits and to maintain relationships with sellers who have ongoing need to sell PMSRs, Arvest also sells selected PMSRs on a regular basis. Experience has been favorable in that the market values of MSAs sold exceed recorded values helping to validate that carrying values are less than market. For example, 13 sales transactions (involving over \$33 billion in loans balances) occurred from June 2009 through February 2013, all of which resulted in net gains (i.e., net proceeds less carrying values of the MSAs sold was positive). Even the three sales in 2009, during one of the most adverse times of the financial markets crisis, resulted in a net gain. The regulator's question of "Can you sell MSAs without large loss when you need the liquidity" is answered in the affirmative.

Furthermore, the results of profitable sales over a lengthy period, including highly stressed markets, evidences that MSAs are clearly different from Goodwill (dollar-for-dollar capital required under the Current Rule and Proposed Rule) and from the other components of the 15% limitation bucket of the Proposed Rule, especially Deferred Tax Assets ("DTAs"). It is not advisable to lump marketable assets with non-marketable assets in the 15% limitation as this mixes widely varying risks as if they are similar and almost assuredly miss-assigns capital.

While Arvest focused its early efforts in providing exceptional service to its core customers whose loans had been sold into the secondary market with servicing retained, it became quickly obvious the customers related to purchased MSAs also appreciated enhanced service. In order to improve customer service further, Arvest became active very early in loan modifications to try to avoid foreclosures that could be avoided. This effort with loan modifications often required innovative solutions in working with pool managers and other entities that owned the loan. While not always able to obtain approval for a modification, a great many were accomplished helping homeowners stay in their homes. For example, during 2007-2008, Arvest was able to modify more than 3,000 loans often having to proactively work directly with investors and MBS pool managers to have necessary changes made to servicing agreements to authorize the modification. In 2009 the federal government loan modification programs began to come on line which helped raise the total modifications completed to nearly 7,000 in that year alone, many of which happened before the new programs were implemented.

There exists a public policy issue as to whether home loan servicing is best provided by entities with long established credentials in mortgage finance, by highly concentrated high volume servicers or by a broad spectrum of different types of firms. Arvest has built its business in part on providing high levels of service to home loan borrowers and in developing innovative ways to address industry issues. As previously mentioned, Arvest views servicing home loans for core retail bank customers as a fundamental part of the customer relationship whether or not the loan is sold (loans are primarily sold to manage the interest rate risk of fixed rate lending) and seeks to extend a similar high level of service to the PMSR borrower where no core bank relationship exists. As noted above, Arvest was quick to develop loan modification capabilities and by 2008 was actively engaged in doing so before government programs began to emerge. Furthermore, Arvest was an early participant in the Freddie Mac GCX (Gold Cash Extra) program that provides small-to-mid sized originators an avenue to sell the originated loan and not be required to service. Arvest also helped develop and currently participates in two Fannie Mae programs – SET (Servicing Execution Tool) and CAE (Central Advantage Execution) that are designed to facilitate the transfer of servicing from originators not able to service to highly experienced servicers who pay a varying premium for the MSA based on whether or not the originating risk is accepted by the servicer (SET) or not (CAE). This bifurcation of risk allows smaller originators to have greater choice of risk and reward and, thus, encourages the presence of a broader range of smaller originators in the home loan market.

Of note, over the past several years when many of the larger banks restricted their purchase of Whole Loans from smaller originators and curtailed warehouse and correspondent lending to home loan originators, Fannie and Freddie became the primary purchasers of loans originated by smaller originators. The GSEs did so but only with a cadre of reliable servicers capable of purchasing the MSAs and capable of servicing over the long term. Arvest has been one of those select servicers who helped fill the void.

Firms like Arvest also help to make a market for MSAs by regularly buying MSAs and being willing to sell on occasion. This role helps to provide liquidity to the overall MSA market, at least for the GSE loan segment which today is the predominant sector. As with any market, the fewer market participants, the less liquidity and less depth to market values.

Arvest has pursued a deliberate course to manage its risks of servicing by purchasing MSAs without the “origination risks” so that a material portion of its total MSA book has such risk left with the originator. This positioning results in lower overall operational and legal risks which lessens the probability and magnitude of loss. However, the Proposed Rule in no way considers this risk reduction.

During the most severe and adverse economic conditions in the US since the 1930s, the Arvest servicing business held up well as illustrated below for its PMSR business (in thousands):

Description	2008 thru 2010	2008 thru 2012
Total Revenues	\$290,204	\$547,907
MSA amortization	\$115,972	\$201,103
MSA impairment	\$2,238	\$7,538
Net Income	\$22,581	\$25,601

The above table shows for the three years during the worst of the financial market crisis (2008-2010) that the PMSR portfolio showed an after-tax profit in spite of nearly \$118 million in amortization and impairment of MSAs. The same is true when extending the period another two years which works to capture the effects of late arising loan defaults and related litigation and other expenses. Even during this high stress period, the PMSR book was profitable and did not impair bank capital.

The MSAs related to the originated but sold with servicing retained (i.e., OMSR book), had a different experience and incurred a net loss of about \$12,583,000 over the 2008-2012 period reflecting higher levels of impairment as the underlying loans were all traditional long-term fixed rate loans of overall higher credit quality and in locales less hard hit by the recession. For a variety of reasons, these loans were more easily refinanced leading to impairment. However, these loans were refinanced by Arvest over 50% and led to new OMSRs being recorded for the new servicing rights retained which served to offset some of the impairment loss. The high level of refinance reflects the very active Arvest efforts to help customers take advantage of lower interest even though that also leads to higher amortization and impairment costs for the bank. Note that this data excludes profits from the core mortgage loan origination business that more than offset these servicing losses.

In total, during a high stress environment, the total MSA book was modestly profitable which illustrates that MSAs can hold up at least minimally well in aggregate value in severe stress and points to the importance of a diverse MSA book. It should be noted that no time during this period did the combined MSA book show a fair value to book value ratio of less than 112%. Even

after reducing fair values for the 90% FDICIA cap used in the Current Rule capital calculation, the ratio was never below 101%.

While accounting rules for MSAs have not changed in major ways during this period, the attention given by both external auditors and regulatory examiners have sky-rocketed to where this area receives more scrutiny than all other areas except credit quality for problem loans. This intense level of audit and examination attention, including their use of specialized personnel skilled in MSAs, is a major new factor in assurance of carrying values as compared to before the financial market crisis. External auditors and regulatory examiners focus efforts not only on overall model workings but also on key components such as assumptions and inputs.