February 4, 2013

Honorable Thomas J. Curry
Comptroller of the Currency
Office of the Comptroller of the Currency
250 E Street SW
Washington, DC 20219

Honorable Ben S. Bernanke
Chairman
Federal Reserve
20th St. and Constitution Ave NW
Washington, DC 20551

Honorable Martin J. Gruenberg
Chairman
Federal Deposit Insurance Corporation
550 17th Street NW
Washington, DC 20427

Elisse B. Walter
Acting Commissioner
Securities Exchange Commission
100 F Street NE
Washington, DC 20549-1090

Re: Volcker Rule and Hedging Activity in the Mortgage Banking Industry

Dear sirs and madam:

The Mortgage Bankers Association[1] (MBA) is writing this letter because of concerns our members have relating to recent statements made by various parties with respect to hedging activities and the proposed Volcker Rule. Those statements indicate that the final Volcker Rule may adversely impact the ability of mortgage bankers to hedge interest rate lock commitments (rate locks), loans held for sale, and mortgage servicing rights (MSRs) against changes in interest rates. In particular, last summer Federal Reserve Governor Sarah Bloom Raskin stated in a speech to the Colorado Graduate

[1] The Mortgage Bankers Association (MBA) is the national association representing the real estate finance industry, an industry that employs more than 280,000 people in virtually every community in the country. Headquartered in Washington, D.C., the association works to ensure the continued strength of the nation's residential and commercial real estate markets; to expand homeownership and extend access to affordable housing to all Americans. MBA promotes fair and ethical lending practices and fosters professional excellence among real estate finance employees through a wide range of educational programs and a variety of publications. Its membership of over 2,200 companies includes all elements of real estate finance: mortgage companies, mortgage brokers, commercial banks, thrifts, REITs, Wall Street conduits, life insurance companies and others in the mortgage lending field. For additional information, visit MBA's Web site: www.mortgagebankers.org.

School of Banking that the financial system would be better off if banks ceased market making and hedging because the combined regulatory, compliance and other costs could "outweigh the benefits we as a society supposedly receive." Further, on September 14, 2012, CFTC Commissioner Bart Chilton told CNBC's *Squawk Box*, "If over time that hedging of your risk continues to result in large profits and you're making a lot more money than the risks that you're losing, then you have to say there's a presumption that they're willful and trying to be evasive, and we should go after them with the full extent of the law."

MBA below provides some background information on how mortgage bankers prudently use hedges to mitigate interest rate risk associated with rate lock commitments to consumers, closed loans held for sale into the secondary market, and to hedge prepayment risk on MSRs.

Hedges of Rate Locks and Loans Held for Sale

Banks provide mortgage applicants with the ability to lock in an interest rate on their mortgage loan while the mortgage loan is still being underwritten and processed. This allows consumers to lock in a rate that will be used to underwrite their mortgage application, so that if rates in the market go up, the borrower will still be able to close the loan at the rate for which he or she was initially qualified. If not hedged, banks would be at risk of closing a loan that is "underwater" from a market standpoint if rates rise. Therefore, banks enter into hedges to both mitigate this interest-rate risk and to provide a benefit of certainty to the consumer.

Banks generally enter into forward TBA[2] contracts whereby the bank agrees to deliver the loans in process into a future Ginnie Mae, Fannie Mae or Freddie Mac MBS in 30-to-90 days at a specified price, creating a hedge for the bank. Once a loan is closed, the loan held for sale is hedged by those same forward TBA contracts until the pool is created and the forward trade is settled. Hedging loans in pipeline and inventory is a safe and sound practice that should be allowed unfettered under the final Volcker rule. Entering into a forward TBA hedge puts the bank into a "risk neutral" position that preserves the revenue margin needed to cover the bank's loan origination operating expenses and return on capital. If the final Volcker prohibited or somehow impaired banks from hedging loans in pipeline, borrowers would be forced to accept a rate lock

[2] TBA stands for "To Be Announced." It is the forward trade or forward purchase of a mortgage-backed security (security number unspecified) to be delivered at a specified future date.

much later in the process—most likely near to the time the loan closes. Furthermore, banks would be unnecessarily exposed to potentially significant earnings volatility and associated capital uncertainty.

In volatile rate environments, this may have the perverse effect of negating a borrower's ability to qualify for the loan. Should mortgage interest rates rise, even by small amounts, between the time a contract is signed and the loan application is complete, approved, and ready to be priced and closed,[3] the borrower may no longer qualify due to the higher payment associated with the higher rate. This may cause the borrower to lose his/her earnest money deposit, and potentially trigger other adverse outcomes.

Interaction With RESPA and TILA

Restricting a bank's ability to hedge may also cause unintended consequences with respect to disclosures required under the Real Estate Settlement Procedures Act (RESPA) and the Truth in Lending Act (TILA). As already pointed out, prohibiting banks from hedging using TBA instruments will make it very difficult for many lenders to provide their customers with rate locks early in the mortgage application process or will result in significant charges to consumers in order to compensate for the additional market risk of fluctuating rates. Consumers will be unable to receive locked rates until later in the process, even as late as the closing table, rendering irrelevant the early disclosures required under RESPA and TILA and delaying the point at which a consumer will know the true cost of their mortgage. The mortgage disclosure process was designed to allow consumers to thoughtfully weigh their options and the potential unavailability of rate locks would undermine this goal by imposing more time pressure and greater costs.

Competitive Disadvantage for Banks

The Volcker rule applies only to regulated depository institutions. In addition to the proposed Volcker rule, banks are also challenged by proposed Basel III rules that would treat real estate finance assets and services in a very harsh manner from a regulatory capital standpoint. The proposed Basel III rules coupled with Volcker rule restrictions on hedging could very well force many financial institutions out of the mortgage banking industry, or to significantly curtail future involvement in mortgage banking activities. MBA does not believe that there is sufficient available capital outside of the banking

[3] This process typically takes 30-90 days.

industry to support a vibrant and competitive mortgage finance market. This would adversely impact consumers.

Hedges of MSR Assets

MSR assets contain multiple risks, including interest rate, credit, operational, regulatory and other risks. Some of these risks can be effectively hedged, while others cannot be hedged on a cost-efficient basis. For example, the overall fair value of an MSR is influenced by many factors, some affecting interest rate risk, some affecting credit risk, and some affecting the cost to service the underlying loans. Changes in laws and regulations can also impact the value of servicing rights. Because entities do not and cannot hedge all risks in MSRs, mortgage banking companies have generally elected to hedge the interest rate risk of a loan prepaying, identifying changes in a benchmark interest rate as the specified hedged risk. They elect not to attempt to hedge the risks associated with changes in delinquency of the underlying loans and other risks that may independently impact fair value from time to time. The MBA believes that the ability to bifurcate-by-risk allows banks to hedge the primary risk of MSRs in a cost-efficient manner. From time to time, a bank may have a large gain in its MSR hedge position that is not matched by a similar loss in the value of the MSR asset. An anomalous outcome of this sort is not necessarily indicative of "proprietary trading" or market speculation. Rather, this sort of outcome can easily result from changes in the other factors that influence the valuation of the MSR, including changes in delinquencies, changes in assumed servicing costs, changes in assumed earning rate on escrow balances, changes in market volatility, basis risk inherent in the mix of selected hedge instruments, and other factors not related to the interest-rate risk the bank hedges. Nevertheless, retaining the ability to isolate the hedged risk is critical to efficient risk management.

MBA thus disagrees with the assertion that by CFTC Commissioner Chilton that if you're making more money on the hedge than the loss on the hedged item that you are somehow being willful and evasive. To the contrary, substantially offsetting changes in value due to changes in interest rates is the fundamental objective of prudent interest rate risk management. Outperformance due to other "unhedged" factors is neither relevant nor undesirable. Therefore, MBA recommends that the final Volcker Rule be drafted in a manner that will continue to allow banks to hedge the interest rate risk inherent in MSR assets.

MBA observes that servicing assets are already "return-challenged" because of existing bank regulatory capital rules. The proposed treatment under Basel III will exasperate

the problem. The inability to hedge the interest rate risk inherent in the asset may force some banks to exit or significantly reduce this line of business.

Hedge Effectiveness in Proposed Volcker Rule

The proposed Volcker Rule requires derivatives in a designated hedge to meet certain hurdles of hedge effectiveness as follows:[4]

- "Hedges or mitigates one or more specific risks, including market risk, counterparty or other credit risk, currency or foreign currency exchange risk, interest rate risk, basis risk, or similar risks, arising in connection with and related to individual or aggregated positions, contracts, or other holdings of a covered banking entity …"
- "Is reasonably correlated, based upon the facts and circumstances of the underlying and hedging positions and the risk or risks the purchase or sale is intended to hedge or otherwise mitigate."
- "Maintains a reasonable level of correlation based upon the facts and circumstances of the underlying and hedging positions …"

The above language is similar to existing language in GAAP which states that, "Both at inception of the hedge and on an ongoing basis, the hedging relationship is expected to be highly effective in achieving offsetting changes in fair value attributable to the hedged risk during the period that the hedge is designated."[5]

MBA notes that in practice, the FAS 133 standards which call for a "highly effective" threshold have resulted in ever-evolving interpretations by the accounting firms and others. This dynamic has resulted in hundreds of restatements and what is essentially a "form over substance" practice. Finally, FASB stepped in with two new pronouncements that allowed for a fair value option for MSR assets (FAS 156) and a fair value option for financial instruments (FAS 157). This option preempts hedge effectiveness testing because both the hedge instrument and the hedged item are fully accounted for at fair value, with changes in fair value going through the income statement at the close of

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[4] *Proprietary Trading and Certain Interests In and Relationships With Covered Funds,* Federal Register, November 7, 2011, page 68948.

[5] Statement of Financial Accounting Standards No. 133, *Accounting for Derivative Instruments and Hedging Activities,* page FAS 133-17.

each accounting period. This accounting approach is very transparent, and has been adopted by most firms engaged in mortgage banking businesses.

If the final Volcker Rule were to require FAS 133-like hedge effectiveness testing, the infrastructure required to document such effectiveness would make many community banks "too small to comply."

Since 2008 both FASB and IASB have been working on a new hedge accounting model --- one that would call for qualitative vs. quantitative hedge effectiveness testing with a measurement standard of "reasonably effective."

MBA recommends that the final Volcker Rule should specify qualitative hedge effectiveness testing and documentation and a measurement standard of "reasonably effective."

MBA thanks the Fed, OCC, FDIC and SEC in advance for considering MBA's suggestions. Any questions should be directed to Jim Gross, Vice President of Financial Accounting and Public Policy at (202) 557-2860 or jgross@mortgagebankers.org, or Dan McPheeters, Policy Advisor (202) 557-2780 or dmcpheeters@mortgagebankers.org.

Sincerely,

David H. Stevens
President and Chief Executive Officer