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Revitalizing Bank Mortgage Lending, One Step with Basel

Remarks by

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at

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It is a pleasure to join you again this year for the American Bankers Association Community Bankers Conference. As a former community banker, I always enjoy taking time to learn from your experience to inform my work at the Federal Reserve.¹

Today, I would like to discuss a concerning trend in our financial system that has significant implications for the banking industry, the stability of the mortgage market, and consumers. Whether due to a conscious decision in response to the regulatory environment or other factors, we have seen a significant migration of mortgage origination and servicing out of the banking sector. The data tells a clear story. In 2008, banks originated around 60 percent of mortgages and held the servicing rights on about 95 percent of mortgage balances. Since that time, the contraction has been extraordinary. As of 2023, banks originated only 35 percent of mortgages and serviced about 45 percent of mortgage balances.²

Taking a step back to understand the magnitude of this change, as regulators, we have a responsibility to determine whether prudential regulations have driven this shift. We should also consider whether the regulations are appropriately calibrated to the risk that mortgage origination and servicing pose to the banking system. This out-migration of origination and servicing has been costly for banks, consumers, and the overall mortgage system. In part, this results from over calibration of the capital treatment for these activities, resulting in requirements that are both disproportionate to risk and that make mortgage activities too costly for banks to engage. I

¹ The views expressed here are my own and are not necessarily those of my colleagues on the Federal Reserve Board or the Federal Open Market Committee. I thank Karen Pence for her assistance with these remarks.

² Statistics are tabulated from Home Mortgage Disclosure Act (HMDA) data (originations) and Inside Mortgage Finance (servicing). HMDA tabulations are for closed-end, first-lien purchase mortgages collateralized by owner-occupied, site-built one-to-four family properties. Banks include commercial banks, thrifts, and credit unions. Bank market share in 2008 was a bit high by historical standards because some large nonbanks went out of business in 2007 and 2008. The Financial Stability Oversight Council (FSOC) has published a report on nonbank mortgage servicing that provides a longer time series. See FSOC, *Report on Nonbank Mortgage Servicing 2024*, <https://home.treasury.gov/system/files/261/FSOC-2024-Nonbank-Mortgage-Servicing-Report.pdf>.

see a path forward that incorporates both renewed bank participation in the mortgage market and a safe and sound banking system.

Why This Migration Matters

For Banks: Mortgages are an important component of the business model. This is not only from a revenue perspective, but because banking is fundamentally a relationship business. The purchase of a home is a major life milestone, and banks should be able to offer this service to their customers. In addition, most banks prefer to retain mortgage servicing in-house to ensure positive customer experiences. We know that servicing creates customer loyalty when done well but can create significant frustration when done poorly.

The relationship benefits that the mortgage business offers are substantial. Customers with strong bank connections naturally turn to that bank for other financial needs, from checking accounts to investment services. This can create a virtuous circle—good customer service in the mortgage business can lead to a stronger relationship with customers and result in improved bank financial resiliency. Mortgage servicing also offers distinct financial benefits. The fee income from mortgage servicing diversifies a bank's revenue stream from an over-reliance on lending income, providing more stable income independent of the interest rate environment.

Banks also have structural advantages in servicing. The customer relationships built through mortgage lending may be more valuable for banks than nonbanks because they can cross-sell more products and services than nonbanks. Escrow balances must be held in insured accounts, providing banks with funds to support lending activities as they would those in any other deposit account. Many servicing contracts require the servicer to advance principal, interest, and other payments on behalf of delinquent borrowers. Banks can more easily comply

with these requirements than nonbanks because banks have access to stable, low-cost sources of funding.

For Consumers: Turning next to consumers, fewer banks engaged in mortgage origination and servicing has reduced the consumer choice and competition that drives down costs. In addition, borrowers that experience financial distress seem to fare worse during financial downturns with nonbank servicers. During COVID-19, borrowers with bank servicers were more likely to receive forbearance on their mortgage payments than those with nonbank servicers.³

For Financial Stability: Nonbank servicers face other vulnerabilities, as described in a recent report issued by the Financial Stability Oversight Council.⁴ Perhaps the greatest risk they present is that the regulatory and resolution frameworks for these mortgage companies have not kept pace with their growth. When a large bank servicer fails, regulators have tools to ensure core servicing functions continue—requiring that borrower mortgage payments are credited correctly and that borrowers in financial distress receive appropriate modifications. Nonbank servicers are subject to far fewer safeguards.

The Capital Treatment Challenge

We can clearly see from academic research and industry feedback that the 2013 change in capital treatment of mortgage servicing rights was a factor in the withdrawal of banks from the

³ See Susan Cherry, Erica Jiang, Gregor Matvos, Tomasz Piskorski, and Amit Seru, “Government and Private Household Debt Relief during COVID-19,” *Brookings Papers on Economic Activity* (Fall 2021), https://www.brookings.edu/wp-content/uploads/2021/09/15985-BPEA-BPEA-FA21_WEB_Cherry-et-al.pdf; You Suk Kim, Donghoon Lee, Tess Scharlemann, and James Vickery, “Intermediation Frictions in Debt Relief: Evidence from CARES Act Forbearance,” *Journal of Financial Economics* 158 (2024), <https://doi.org/10.1016/j.jfineco.2024.103873>.

⁴ See <https://home.treasury.gov/system/files/261/FSOC-2024-Nonbank-Mortgage-Servicing-Report.pdf>.

mortgage market.⁵ When a financial institution securitizes a mortgage by selling it to a securitization trust, the institution receives a “mortgage servicing right,” or MSR, as a byproduct of the sale. That MSR represents the expected present value of the net servicing income that the institution will receive over the life of the mortgage—including the anticipated servicing fees minus the expenses.

These changes to the MSR capital treatment were two-fold. First, most banks experienced modest to moderate increases in their risk weights for MSRs, depending on how the banks accounted for the MSRs on their balance sheets.⁶ Second, banks holding significant amounts of MSRs faced an even more stringent capital treatment, in that any MSRs exceeding a certain percentage of capital (called the “deduction threshold”) received disproportionately high risk weights.

Reconsidering the Balance

At the time, regulators tightened MSR capital treatment for sound reasons. MSR valuations can be challenging to calculate because they are not based on transaction prices in liquid markets. Instead, they are derived from models that depend on subjective assumptions about mortgage prepayment and the likelihood of default. This makes the valuations volatile, especially during interest rate swings, and we have observed that during periods of high defaults, some MSR markets can experience stress or seize up.

⁵ Greg Buchak, Gregor Matvos, Tomasz Piskorski, and Amit Seru, “Fintech, Regulatory Arbitrage, and the Rise of Shadow Banks,” *Journal of Financial Economics* 130 (2018), <https://doi.org/10.1016/j.jfineco.2018.03.011>.

⁶ For more information on the changes in MSR capital treatment, see *Report to the Congress on the Effect of Capital Rules on Mortgage Servicing Assets* (Board of Governors, June 2016), <https://www.federalreserve.gov/publications/other-reports/files/effect-capital-rules-mortgage-servicing-assets-201606.pdf>.

These are legitimate concerns, and I want to be clear that holding MSRs is not the right choice for every bank. Successfully managing the volatility in MSR valuations as interest rates change requires sophisticated hedging capabilities or an effective borrower retention strategy during refinancing waves. Servicing can also carry substantial operational risk and compliance responsibility. Banks that engage in mortgage servicing must have sufficient expertise and resources to manage these risks and the associated responsibilities in a safe and sound manner.

That said, regulators are much more familiar with MSRs since the 2013 regulations were put in place, and we have also learned a great deal about how the capital treatment of MSRs has affected bank decisions about mortgage origination and servicing. Turning first to origination, when banks decide whether to originate and how to price mortgages, they consider the value of the MSR that they receive after the securitization sale. The capital treatment makes that MSR less valuable. Since banks securitize roughly 75 percent of their mortgage originations to low-to-moderate income, or LMI, borrowers, the capital treatment may particularly affect mortgage availability and affordability for these borrowers.⁷

Turning next to servicing, we have learned that the deduction threshold may impede a bank's ability to build a profitable servicing business. This effect may be more consequential for smaller banks. Mortgage servicing requires substantial fixed investments in personnel and technology, making it more cost-effective at larger volumes. However, smaller banks may not be able to build a servicing portfolio of that size without creating an MSR in excess of the deduction threshold.

Risk weights for mortgages held in bank portfolios also affect bank decisions about mortgage market engagement and pricing. Are these risk weights calibrated appropriately to the

⁷ Calculation is from HMDA data for owner-occupied, first-lien fixed-rate purchase mortgages.

underlying risk? Consider a mortgage's loan-to-value ratio, or LTV. Capital rules impose the same risk weight regardless of LTV, but default probability and the severity of losses vary substantially with LTV. Low-LTV mortgages carry low expected losses—borrowers have strong incentives to protect their equity, and collateral values well exceed the bank's credit exposure. Further, the risk of a mortgage default decreases over time as the principal is paid down and the mortgage migrates to lower LTV buckets.

This misalignment between capital requirements and actual risk has important consequences. Banks hold substantial numbers of mortgages with low loan-to-value ratios. By requiring disproportionately high capital, we reduce a bank's ability to deploy capital to support the needs of their community. In light of these considerations, I am open to revisiting whether the capital treatment of MSRs and mortgages is appropriately calibrated and is commensurate with the risks.

Proposed Path Forward

While there are many rules that govern bank mortgage origination and servicing, my discussion today focuses on the bank regulatory capital treatment, which represents only a small part of the broader mortgage problem. Comprehensively addressing mortgage market challenges would also require revisiting Consumer Financial Protection Bureau rules and legislative requirements. Let me highlight a few areas within the Basel framework that could effectively address some challenges and that we are considering for potential modification.

Two regulatory proposals will soon be introduced that, among other broader changes to the regulatory capital framework, would increase bank incentives to engage in mortgage origination and servicing. First, the proposals would remove the requirement to deduct mortgage servicing assets from regulatory capital while maintaining the 250 percent risk weight assigned

to these assets. We will seek comment on the appropriate risk weight for these assets. This change in the treatment of mortgage servicing assets would encourage bank participation in the mortgage servicing business while recognizing uncertainty regarding the value of these assets over the economic cycle.

Second, the proposals would also consider increasing the risk sensitivity of capital requirements for mortgage loans on bank books. One approach would be to use loan-to-value ratios to determine the applicable risk weight for residential real estate exposures, rather than applying a uniform risk weight regardless of LTV. This change could better align capital requirements with actual risk, support on-balance-sheet lending by banks, and potentially reverse the trend of migration of mortgage activity to nonbanks over the past 15 years.

These potential changes would address legitimate concerns about mortgage market structure while maintaining appropriate prudential safeguards. I look forward to receiving feedback from industry and other stakeholders as we consider these modifications.

Closing Thoughts

By creating a resilient mortgage market that includes robust participation from all types of financial institutions, we can deliver affordable credit and high-quality servicing to borrowers regardless of economic conditions. Strengthening bank participation in these activities does not threaten the safety and soundness of the banking system. These goals are consistent.

I look forward to working with my fellow regulators to consider options for creating pathways to return banks to their traditional and core business services, including in the retail mortgage space.

Thank you again for the invitation to join you today, and I look forward to our discussion.