# Mortgage Bankers Association

## Basel III Final Rule

## Mortgage Products Impact and Treatment of Community Banks

On July 2, 2013, the Federal Reserve Board approved the Basel III Regulatory Capital and Market Risk Final Rule (Final Rule). The following summarizes the impact of the Final Rule on mortgage banking assets with special emphasis on community bank impact.

**Mortgage Servicing Assets (MSAs)**

Mortgage servicing assets were not given favorable treatment in the Final Rule. The Final Rule requires that the following assets that individually exceed 10 percent of the common equity component of tier 1 capital be deducted from that component of tier 1 capital:

- Mortgage Servicing Assets defined as contractual rights owned by the bank to service for a fee mortgage loans owned by others.
- Deferred Tax Assets (DTAs) arising from temporary differences that the bank could not realize through net operating loss carrybacks.
- Significant investments in the capital of unconsolidated financial institutions in the form of common stock.

In addition, the aggregate of all assets in the above categories that exceed 15 percent of the common equity component of tier 1 capital must be deducted from that component of tier 1 capital. In addition, any MSAs not deducted from capital would be risk-weighted at 250 percent. The present risk-weight of MSA's is 100 percent.

However, the regulators agreed with MBA's comment letters in three MSR-related areas:

- The existing 10 percent haircut of MSA's from capital under section 475 (b) of FIDICIA will be removed.
- Under the proposed rule, any non-cash gain on sale recorded for securitization interests (multi-tranche securities) would have to be reversed. Under the final rule, the gain on sale associated with the set-up of an MSA on securitization would not have to be reversed.
- In 2011, MBA sent a pre-emptive letter to the regulators requesting that deferred tax liabilities associated with the MSA tax safe harbor be used to offset MSA's used in the 10 percent and 15 percent limits above. The proposed rule and final rule allow such offset.

The Final Rule allows for a five year phase-in commencing January 1, 2014.

**Residential Mortgages**
The proposed rule would have required banks to place each individual loan into Category 1 or Category 2, based upon various underwriting and documentation standards, and to assign risk-weights based upon these categories and the loan-to-value (LTV) ratio, ignoring private mortgage insurance in the LTV calculation. The risk-weights would be in the range of 35 percent to 200 percent. Small banks commented to the regulators that the cost of complying with the proposal would have been prohibitive. Under the final rule, regulators agreed to continue to apply the existing risk-based standard for residential mortgage loans which includes a 50 percent risk-weight for prudently underwritten first-lien mortgages that are not past due.

**Risk-Based Capital (RBC) for Commercial and Multifamily Loans**
For commercial and multifamily mortgages held in bank portfolios, the Final Rule has negligible impact. The Final Rule maintains the 8 percent RBC requirement (100 percent risk-weight) for the $838.9 billion in bank mortgages for existing properties (non-construction mortgages) that are held in portfolio.

**Treatment of Accumulated Other Comprehensive Income (AOCI)**
Most banks carry mortgage-backed securities (MBS) in the accounting category *Available for Sale* (AFS). Such AFS assets are carried in the balance sheet at fair value, with changes in fair value going through the Accumulated Other Comprehensive Income in the equity section of the balance sheet. Under current risk-based capital rules, regulatory capital excludes AOCI. Under the Basel III rule proposed in 2012, AOCI would be included in the calculation of regulatory capital, making regulatory capital potentially more volatile. Under the Final Rule, banks reporting under the standardized approach, which includes all but the largest banks, will have the opportunity to elect to exclude AOCI from regulatory capital. This will be an irrevocable, one-time election.

**Small Bank Holding Company Exemption**
The Final Rule does not apply to small bank holding companies with less than $500 million of assets that are not engaged in significant nonbanking activities, do not conduct significant off-balance sheet activities, and do not have a material amount of debt or equity securities outstanding that are registered with the SEC. Small bank holding companies remain subject to the Fed's Small Bank Holding Company Policy Statement. This exemption is specifically established in Section 171 of Dodd-Frank.

Section 171 of Dodd-Frank does not provide a similar exemption for small savings and loan holding companies, and they are therefore subject to the Basel III capital standards unless there is a subsequent legislative fix to put them on a level playing field with small bank holding companies.

**Grandfathering Certain Capital Instruments for Small Banks**

The Final Rule permanently allows certain non-qualifying instruments be included in the tier 1 capital of depository institution holding companies with total consolidated assets of less than $15 billion as of December 31, 2009. These include Trust Preferred Stock and cumulative perpetual preferred stock issued before May 19, 2010 that banks included in tier 1 capital under the limitations for restricted capital elements in the general risk-based capital rules.