



Capital Standards

FIL-79-97
August 8, 1997

TO: CHIEF EXECUTIVE OFFICER
SUBJECT: *Proposed Revisions to Regulatory Capital Treatment of Servicing Assets*

The FDIC Board of Directors has issued for public comment the attached proposal to ease limits on the volume of mortgage servicing assets (MSAs) that FDIC-supervised banks can recognize in calculating Tier 1 capital. The proposed rule was developed in consultation with the Federal Reserve Board (FRB), the Office of the Comptroller of the Currency (OCC) and the Office of Thrift Supervision (OTS), and is being issued jointly by the FDIC and the other federal banking agencies. The agencies will accept comments on the proposal through October 3, 1997.

If adopted, the rule would reduce the burden on banks by relaxing the capital limitation on MSAs and aligning the terminology used in the FDIC's capital standards more closely with that used under generally accepted accounting principles (GAAP). One example is replacing the term "mortgage servicing rights" used in current capital rules with "mortgage servicing assets."

Under the proposal, the limitation on the amount of MSAs (both purchased and originated)--when combined with purchased credit card relationships (PCCRs)--that can be recognized in regulatory capital would be increased from 50 percent to 100 percent of Tier 1 capital. MSAs exceeding this limit would be deducted from assets and capital in calculating Tier 1 capital. The treatment of PCCRs--which represent the value of the customer relationships obtained with the purchase of credit card accounts--would not be changed under the proposed rule. Therefore, PCCRs would continue to be subject to a sublimit of 25 percent of Tier 1 capital. Consistent with current capital standards, the amount of MSAs and PCCRs that may be recognized for Tier 1 capital purposes also would remain limited to the lesser of 90 percent of fair value or 100 percent of book value (net of any related valuation allowances).

The FDIC is not proposing to change the existing regulatory capital treatment of servicing assets related to financial assets other than mortgages (non-MSAs), which must be fully deducted from capital and assets in determining the amount of Tier 1 capital. Although the markets for some types of non-MSAs are growing, these markets are not as fully developed as the mortgage servicing market. Because of the uncertainty surrounding the valuation of these servicing rights, the FDIC would continue to exclude non-MSAs from Tier 1 capital.

Servicing rights (or assets) represent the contractual obligations undertaken by an institution to provide the servicing for loans owned by others, typically for a fee. These rights can be acquired through a purchase of the rights from another party or through the origination of loans that the institution then sells or securitizes while retaining the servicing rights.

The accounting rules for servicing rights under GAAP have changed significantly over the past few years. Before 1996, only purchased servicing rights could be recorded as balance sheet assets. In 1996, the Financial Accounting Standards Board's Statement No. 122, 'Accounting for Mortgage Servicing Rights' (FASB 122), permitted institutions to also recognize originated

mortgage servicing rights as assets. Beginning this year, institutions must adopt the Financial Accounting Standards Board's Statement No. 125, 'Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities' (FASB 125). Under this standard, institutions now record servicing assets (or liabilities) on the balance sheet for all financial assets that they service for others (including servicing of financial assets other than mortgages), regardless of the manner in which the servicing is acquired.

The FDIC previously limited the amount of mortgage servicing rights that an institution could include in regulatory capital. This was due to the significant adverse impact on capital that could result from a high concentration of these assets, which are potentially volatile because of interest rate and prepayment risk. However, the FDIC believes that a higher limit is more reasonable in light of the specific valuation and impairment guidance for servicing assets in the current accounting standards. In addition, some institutions may exceed the current Tier 1 capital limitation only because of changes in the measurement of MSAs under FASB 125.

The attached Federal Register notice contains a detailed discussion of the proposed rule. The notice also includes specific questions for comment, including whether assets representing rights to future interest cash flows from serviced assets in excess of contractually specified servicing fees--so-called 'interest-only strips receivable'--should be subject to the same regulatory capital limitations that are applied to servicing assets.

For more information, please contact Stephen G. Pfeifer, Examination Specialist in the FDIC's Division of Supervision, on (202) 898-8904.

Nicholas J. Ketcha Jr.

Director

Attachment

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