



June 2016

MORTGAGE SERVICING

Community Lenders
Remain Active under
New Rules, but CFPB
Needs More
Complete Plans for
Reviewing Rules

GAO Highlights

Highlights of [GAO-16-448](#), a report to the Chairman, Committee on Financial Services, House of Representatives

Why GAO Did This Study

As of September 30, 2015, community lenders held about \$3.1 billion in MSR on their balance sheets. Servicing is a part of holding all mortgage loans, but an MSR generally becomes a distinct asset when the loan is sold or securitized. In response to the 2007–2009 financial crisis, regulators have implemented new rules related to mortgage servicing and regulatory capital to protect consumers and strengthen the financial services industry. GAO was asked to review the effect of these rule changes on U.S. banks and credit unions, particularly community lenders. This report examines (1) community lenders' participation in the mortgage servicing market and potential effects of CFPB's mortgage servicing rules on them, (2) potential effects of the treatment of MSR in capital rules on community lenders' decisions about holding or selling MSR, and (3) the process regulators used to consider impacts of these new rules on mortgage servicing and the capital treatment of MSR.

GAO analyzed financial data, reviewed relevant laws and documents from regulatory agencies, and interviewed 16 community lenders selected based on size and volume of mortgage servicing activities, as well as industry, consumer groups, and federal officials.

What GAO Recommends

CFPB should complete a plan to measure the effects of its new regulations that includes specific metrics, baselines, and analytical methods to be used. CFPB agreed to take steps to complete its plan for conducting a retrospective review of the mortgage servicing rules and refine the review's scope and focus.

View [GAO-16-448](#). For more information, contact Mathew J. Scire at (202) 512-8678 or sciremj@gao.gov.

June 2016

MORTGAGE SERVICING

Community Lenders Remain Active under New Rules, but CFPB Needs More Complete Plans for Reviewing Rules

What GAO Found

Community banks and credit unions (community lenders) remained active in servicing mortgage loans under the Consumer Financial Protection Bureau's (CFPB) new mortgage-servicing rules. Among other things, these rules are intended to provide more information to consumers about their loan obligations. The share of mortgages serviced by community lenders in 2015—about 13 percent—remained small compared to larger lenders, although their share doubled between 2008 and 2015. Large banks continue to service more than half of residential mortgages. Many lenders GAO interviewed said changes in mortgage-related requirements resulted in increased costs, such as hiring staff and updating systems. However, many also stated that servicing mortgages remained important to them for the revenue it can generate and their customer-focused business model.

Banking and credit union regulators' new capital rules changed how mortgage servicing rights (MSR) are treated in calculations of required capital amounts, but GAO found that these new rules appear unlikely to affect most community lenders' decisions to retain or sell MSR. For example, GAO found that in the third quarter of 2015, about 1 percent of community banks had to limit the amount of MSR that counted in their capital calculations due to the amount of these assets they held. This may result in some institutions choosing to raise additional capital or sell MSR to meet required minimum capital amounts, depending on banks' holdings of other types of assets. A few banks with large concentrations of MSR that GAO spoke with said they were considering selling MSR or other changes to their capital but market participants told us that the MSR capital treatment was only one of several factors influencing their decisions. Separate capital rules for credit unions also are unlikely to affect most credit unions. For example, credit unions told GAO they did not expect to make changes to their MSR holdings and one credit union explained that it is because MSR represented a small percentage of their overall capital.

Banking regulators and CFPB estimated the potential impacts of their new rules prior to issuing them by, for example, estimating potential costs of compliance. Banking regulators included the capital rules in a retrospective review of all their rules required by statute, although this review is to be completed before the MSR requirements are fully implemented by the end of 2018. Banking regulators also said they often conduct other informal reviews as needed to evaluate their rules' effectiveness. CFPB also has a statutory retrospective review requirement, but its plans for retrospectively reviewing its mortgage-servicing rules are incomplete. CFPB has not yet finalized a retrospective review plan or identified specific metrics, baselines, and analytical methods, as encouraged in Office of Management and Budget guidance. In addition, GAO found that agencies are better prepared to perform effective reviews if they identify potential data sources and the measures needed to assess rules' effectiveness. CFPB officials said it was too soon to identify relevant data and that they wanted flexibility to design an effective methodology. However, without a completed plan, CFPB risks not having time to perform an effective review before January 2019—the date by which CFPB must publish a report of its assessment.

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Abbreviations

ABA	American Bankers Association
CET1	common equity tier 1
CFPB	Consumer Financial Protection Bureau
CUNA	Credit Union National Association
Dodd-Frank Act	Dodd-Frank Wall Street Reform and Consumer Protection Act
EGRPRA	Economic Growth and Regulatory Paperwork Reduction Act of 1996
FDIC	Federal Deposit Insurance Corporation
Federal Reserve	Board of Governors of the Federal Reserve System
FFIEC	Federal Financial Institutions Examination Council
MBS	mortgage-backed securities
MSR	mortgage servicing rights
NCUA	National Credit Union Administration
OMB	Office of Management and Budget
PRA	Paperwork Reduction Act of 1995
RFA	Regulatory Flexibility Act
SBREFA	Small Business Regulatory Enforcement Fairness Act of 1996

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June 23, 2016

The Honorable Jeb Hensarling
Chairman
Committee on Financial Services
House of Representatives

Dear Mr. Chairman:

Many community banks and credit unions (community lenders) view servicing mortgages as important to maintaining their business and satisfying their customers. As of September 30, 2015, community lenders held about \$3.1 billion in mortgage servicing rights on their balance sheets.¹ Recently, these relatively small financial institutions as well as larger banks have become subject to regulatory changes developed in response to the 2007–2009 financial crisis.

These changes are designed, in part, to strengthen the financial services industry, and some are specific to mortgage servicing. The 2010 Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act) directed or gave authority to federal agencies to issue mortgage servicing regulations. In 2013, the Bureau of Consumer Financial Protection (commonly known as the Consumer Financial Protection Bureau or CFPB) issued regulations that require, among other things, prompt crediting of mortgage payment and early intervention for delinquent borrowers.² Further, also in 2013, federal banking regulators adopted new requirements for risk-based capital that are based on international standards (the Basel III framework) developed by the Basel Committee on Banking Supervision, a global standard-setter for prudential bank

¹Although no commonly accepted definition of a community bank exists, the term often is associated with smaller banks (e.g., under \$1 billion in assets) that provide relationship banking services to the local community and have management and board members who reside in the local community. In this report, we use the term “community lenders” to mean community banks and credit unions. Credit union membership is based on a common bond, such as residing in a specific geographic area or working in the same profession.

²Mortgage Servicing Rules Under the Real Estate Settlement Procedures Act (Regulation X), 78 Fed. Reg. 10696 (Feb. 14, 2013); Mortgage Servicing Rules Under the Truth in Lending Act (Regulation Z), 78 Fed. Reg. 10902 (Feb. 14, 2013).

regulation.³ These requirements define how much capital banks must hold for a variety of activities—including for holding mortgage servicing rights (MSR), which are distinct assets that generally are created when a mortgage loan is sold or securitized.⁴

Both the mortgage servicing regulations and the regulatory capital changes for MSRs are relatively new and the effect of these new requirements has not yet been formally evaluated. Industry and trade associations have raised concerns about the potential effect of mortgage servicing regulations on U.S. banks and, in particular, on community lenders. You asked us to examine the effect of mortgage servicing and risk-based capital regulations on community lenders and their customers.⁵ This report examines (1) community lenders' participation in the mortgage servicing market and potential effects of CFPB's mortgage

³Regulatory Capital Rules: Regulatory Capital, Implementation of Basel III, Capital Adequacy, Transition Provisions, Prompt Corrective Action, Standardized Approach for Risk-weighted Assets, Market Discipline and Disclosure Requirements, Advanced Approaches Risk-Based Capital Rule, and Market Risk Capital Rule, 78 Fed. Reg. 62018 (Oct. 11, 2013) (Federal Reserve and OCC) and 78 Fed. Reg. 55340 (Sept. 10, 2013) (FDIC Interim Final Rule). With minor changes, the September 2013 FDIC interim final rule became a final rule in April 2014. See 79 Fed. Reg. 20754 (Apr. 14, 2014). The Basel III framework has no legal force but was issued by the agreement of the Basel Committee members with the expectation that individual national authorities would implement the standards.

⁴In this report, we use the term “mortgage servicing rights” to mean mortgage servicing assets that are recognized on a servicer's balance sheet and are subject to capital deductions and risk-weighting under the federal prudential regulators' risk-based capital rules. Depending upon the facts and circumstances of a given loan sale or securitization transaction, mortgage servicing rights may or may not actually be recognized on a servicer's balance sheet, and when recognized, could actually constitute either a mortgage servicing asset or a mortgage servicing liability. Also, under U.S. Generally Accepted Accounting Principles, certain accounting criteria must be met for the sale to qualify as an accounting sale of servicing assets. For example, the transferor must surrender control of the financial assets to the transferee.

⁵We use the Federal Deposit Insurance Corporation's practical definition of a community bank, which incorporates an asset size threshold—generally including banks with less than \$1 billion in assets—and other characteristics, including if it is part of a banking organization that has loans or core deposits, has limited amounts of foreign assets, has limited amounts of assets in specialty banks like credit card banks or trust companies, and is either relatively small or has large amounts of loans and core deposits and a limited geographic scope. The asset size threshold is not a strict requirement. Larger banks may be considered community banks if they meet other criteria such as having a loan-to-asset ratio greater than 33 percent. See Federal Deposit Insurance Corporation, *FDIC Community Banking Study*, December 2012.

servicing rules on them, (2) potential effects of the risk-based capital treatment of MSR on decisions about holding or selling MSR, and (3) the process regulators used to estimate the impact of regulations addressing mortgage servicing requirements and the risk-based capital treatment of MSR.

To address these objectives, we analyzed quarterly data on banks obtained from the Federal Deposit Insurance Corporation (FDIC) and the Federal Financial Institutions Examination Council (FFIEC) for the period from the first quarter of 2001 through the third quarter of 2015, quarterly data on credit unions obtained from the National Credit Union Administration (NCUA) for the period from the second quarter of 2002 through the third quarter of 2015, and quarterly data on outstanding residential mortgages obtained from the Board of Governors of the Federal Reserve System (Federal Reserve) for the period from the first quarter of 2008 through the third quarter of 2015. We used these data to estimate the shares of residential mortgages serviced by banks and credit unions of different sizes, to assess the extent to which banks and credit unions participate in residential mortgage lending, and to analyze the potential effect on banks of the capital treatment of MSR under risk-based capital rules. We grouped banks into five equal-sized groups, or quintiles, based on their size as measured by total assets, with the first quintile containing the smallest banks and the fifth quintile containing the largest banks. We did the same for credit unions. We assessed the reliability of the data from FDIC, FFIEC, the Federal Reserve, and NCUA for the purposes described above by reviewing relevant documentation and electronically testing the data for missing values, outliers, and invalid values and found the data to be sufficiently reliable for these purposes.

We also analyzed data on transfers of mortgage servicing rights obtained from Fannie Mae, Freddie Mac, and Ginnie Mae for the period from 2010 to 2015. We analyzed the amount of MSR associated with mortgage pools that were sold via bulk sales by banks, credit unions, and nonbank entities. We assessed the reliability of these data for this purpose by electronically testing the variables for missing values, invalid values, and outliers. We found these data to be sufficiently reliable for this purpose.

Finally, we reviewed relevant laws and regulations, as well as past GAO reports on the financial crisis and the implementation of the Dodd-Frank Act. We also interviewed officials from a variety of organizations, including community banks, credit unions, regulators, industry organizations, credit union service organizations, consumer groups, and academics and other industry participants such as mortgage brokers. Our

interviews with a small sample of community lenders and an additional regional bank provided further insights on their participation in mortgage servicing and effects of regulations. The responses are not generalizable to the population of community lenders. Appendix I provides a more detailed description of our scope and methodology.

We conducted this performance audit from April 2015 to June 2016 in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives.

Background

Types of Mortgage Servicers and Federal Regulators

Various institutions, including banks, credit unions, nonbank entities, and subservicers, service mortgage loans.⁶ These institutions are defined as follows:

- **Banks.** Institutions of various types that may be chartered under federal or state law.⁷ One type of bank, community banks, is often associated with smaller banks (e.g., under \$1 billion in assets) that provide relationship banking services to the local community and have

⁶For more information about nonbank mortgage servicers, see GAO, *Nonbank Mortgage Servicers: Existing Regulatory Oversight Could Be Strengthened*, [GAO-16-278](#) (Washington D.C.: Mar. 10, 2016).

⁷For purposes of this report, banks include bank holding companies, financial holding companies, savings and loan holding companies, and insured depository institutions, including any subsidiaries or affiliates of these institutions.

management and board members who reside in the local community.⁸ In addition to mortgage servicing, banks offer a variety of financial products to consumers, including deposit products, loan products, such as mortgage and auto loans, and credit card products.

- *Credit unions.* Member-owned cooperatives run by member-elected boards with an historical emphasis on serving people of modest means. Like banks, credit unions offer a variety of financial, deposit, and loan products to consumers.
- *Nonbank entities.* Entities that are not financial institutions and may be involved in a variety of mortgage activities, including servicing and originating loans. Nonbank entities generally do not offer deposit or credit card products to consumers.
- *Subservicers.* Third-party servicers that have no investment in the loans they service. Banks, credit unions, and nonbanks may outsource loan servicing activities to a subservicer that performs the same administrative functions the bank, credit union, or nonbank would to service the mortgage loan.

All U.S. depository institutions that have federal deposit insurance have a federal prudential regulator that generally may issue regulations and take enforcement actions against institutions within its jurisdiction. The federal prudential regulators, which are the Office of the Comptroller of the Currency (OCC), FDIC, and Federal Reserve, along with the credit-union-regulating NCUA, oversee depository institutions for safety and soundness purposes and for compliance with other laws and regulations

⁸We use the FDIC's definition of a community bank, which incorporates an asset size threshold—generally including banks with less than \$1 billion in assets—and other characteristics, including if it is part of a banking organization that has loans or core deposits, has limited amounts of foreign assets, has limited amounts of assets in specialty banks like credit card banks or trust companies, and is either relatively small or has large amounts of loans and core deposits and a limited geographic scope. The asset size threshold is not a strict requirement. Larger banks may be considered community banks if they meet other criteria such as having a loan-to-asset ratio greater than 33 percent. See Federal Deposit Insurance Corporation, *FDIC's Community Banking Study*.

that fall within the scope of the relevant prudential regulator's authority (see table 1).⁹

Table 1: Federal Prudential Regulators and Their Basic Prudential Functions, as of June 2016

Agency	Basic function
Office of the Comptroller of the Currency	Charters and supervises national banks, federal savings associations (also known as federal thrifts), and federal branches and agencies of foreign banks, supervises subsidiaries of national banks and federal thrifts.
Board of Governors of the Federal Reserve System	Supervises state-chartered banks that opt to be members of the Federal Reserve System, depository institution holding companies (bank holding companies and savings and loan holding companies), and the nonbanking subsidiaries of those entities.
Federal Deposit Insurance Corporation	Supervises state-chartered banks that are not members of the Federal Reserve System, as well as state savings banks and thrifts and state chartered branches of foreign banks; insures the deposits of all banks and thrifts that are approved for federal deposit insurance; has the authority to conduct insurance or backup examinations for any insured institutions; resolves all failed insured banks and thrifts; and has the authority to resolve certain large bank holding companies and nonbank financial companies, if appointed receiver by the Secretary of the Treasury after the statutory process.
National Credit Union Administration	Charters and supervises federally chartered credit unions and insures savings in federal and most state-chartered credit unions.

Source: GAO. | GAO-16-448

Note: The Federal Deposit Insurance Corporation (FDIC) insures deposits in insured banks and thrifts for at least \$250,000. FDIC promotes the safety and soundness of these institutions by identifying, monitoring, and addressing risks to the deposit insurance funds and limiting the effect on the financial system when a bank or thrift fails.

Additionally, the Dodd-Frank Act transferred consumer financial protection regulation and some other authorities regarding certain federal consumer financial laws from other federal banking regulators to CFPB, to help foster consistent enforcement of federal consumer financial laws.¹⁰ CFPB has supervision and primary enforcement authority for most federal consumer financial laws for insured depository institutions with more than \$10 billion in assets and their affiliates as well as certain nonbank entities. The prudential regulators—the Federal Reserve, Office

⁹For a more detailed discussion of the regulatory framework for bank holding companies and savings and loan holding companies, see GAO, *Bank Holding Company Act: Characteristics and Regulation of Exempt Institutions and the Implications of Removing the Exemptions*, GAO-12-160 (Washington, D.C.: Jan. 19, 2012). Nonbank servicers are subject to different safety and soundness regulation and different capital rules. See GAO-16-278.

¹⁰These authorities were transferred on July 21, 2011.

of the Comptroller of Currency, Federal Deposit Insurance Corporation, and NCUA—have primary supervision and exclusive enforcement authority for federal consumer financial laws for institutions that have \$10 billion or less in assets. CFPB also has rulemaking authority to implement provisions of federal consumer financial law. The Dodd-Frank Act authorized CFPB to exercise its authorities for a number of purposes, including ensuring that consumers are provided with timely and understandable information that will help them make responsible decisions about financial transactions; protecting consumers from unfair, deceptive, or abusive acts and practices and from discrimination; and identifying and addressing outdated, unnecessary, or unduly burdensome regulations.¹¹

Mortgage Servicing Market

In the primary market, lenders make, or originate, mortgage loans that are secured by property or real estate.¹² Originators can choose to hold mortgages in their own portfolios or sell them into the secondary market. Servicing is a part of holding mortgage loans in portfolio, but the right to service a mortgage generally becomes a distinct asset—an MSR—when contractually separated from the loan if the loan is sold or securitized. In the secondary market, the government-sponsored enterprises Fannie Mae and Freddie Mac purchase mortgages that meet their underwriting criteria and either hold them in their own portfolios or pool them into mortgage backed securities (MBS) and sell them to investors. Ginnie Mae guarantees the timely principal and interest payments to investors in securities issued by approved institutions through its MBS program. Once the loan origination process is complete, the loan must be serviced until it is paid in full or foreclosure occurs (see fig. 1).

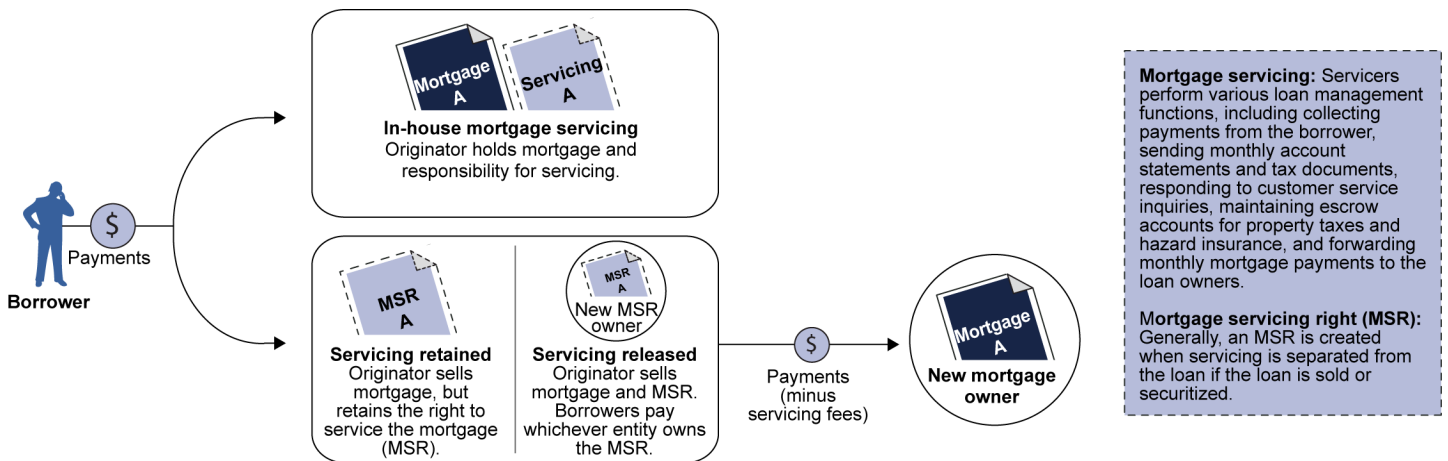
Servicers perform various loan management functions, including collecting payments from the borrower, sending monthly account

¹¹See 12 U.S.C. § 5511(b). CFPB's rules implementing federal consumer financial laws apply to all entities within the scope of a particular rule, including smaller banks. See 12 U.S.C. § 5512(b)(4).

¹²For a more complete discussion of the primary and secondary mortgage markets, see GAO, *Housing Finance System: A Framework for Assessing Potential Changes*, [GAO-15-131](#) (Washington, D.C.: Oct. 7, 2014) and Sean M. Hoskins, Katie Jones, and N. Eric Weiss, Congressional Research Service, *An Overview of the Housing Finances System in the United States*, R42995 (Washington, D.C.: Feb. 19, 2015).

statements and tax documents, responding to customer service inquiries, maintaining escrow accounts for property taxes and hazard insurance, and forwarding monthly mortgage payments to the mortgage owners. In the event that borrowers become delinquent on their loan payments, servicers may offer borrowers the loss mitigation options made available by the owners of the loan, which may include a workout or a loan modification that permits the borrower to stay in the home or other options, such as a short sale. In some cases, the servicer is the same institution that originated the loan. However, servicers may change over the life of a mortgage as MSRs are sold or transferred to other institutions.

Figure 1: Mortgage Servicing and Creation of a Mortgage Servicing Right



Source: GAO. | GAO-16-448

Note: In addition to banks, credit unions and nonbanks, independent mortgage servicers and subservicers may be involved in these arrangements. For instance, subservicers—which are typically nonbanks but can also be banks—may perform some or all servicing functions for the servicer of record but they do not own the mortgage servicing right.

Recent Changes to Selected Mortgage Regulations and Regulatory Capital Requirements for MSRs

Mortgage Origination Rules. CFPB issued new rules related to underwriting of mortgage loans that became effective in January 2014.¹³ Generally, lenders making mortgage loans must make a reasonable, good faith determination of the borrower’s ability to repay the loan. This ability-to-repay determination requires lenders to meet minimum underwriting standards, including consideration and verification of a borrower’s income or assets, debt, and credit history. Lenders are presumed to comply with the ability-to-repay (determination) requirement when they make a qualified mortgage, which is a loan that meets specific product feature and underwriting criteria.¹⁴

Mortgage Servicing Rules. CFPB issued mortgage-servicing-related rules covering nine major topics that became effective January 10, 2014.¹⁵ According to CFPB, the goals of the servicing rules are to provide better disclosure to consumers regarding their mortgage loan obligations, and to inform and assist them with options that may be available if they

¹³Ability-to-Repay and Qualified Mortgage Standards Under the Truth in Lending Act (Regulation Z), 78 Fed. Reg. 6408 (Jan. 30, 2013). Under CFPB’s ability-to-repay and qualified mortgage rule, which, as amended, became effective on January 10, 2014, the agency identified eight underwriting factors a lender must consider in relation to making the required good faith determination of a borrower’s ability to repay, including a borrower’s income, assets, employment, credit history, and monthly expenses. In general, the borrower also must have a total monthly debt-to-income (DTI) ratio, including mortgage payments of 43 percent or less for the loan to have qualified mortgage status. 12 C.F.R. § 1026.43(e)(2)(vi). The ratio represents the percentage of a borrower’s income that goes toward all recurring debt payments, including the mortgage payment. Lenders use the DTI ratio as a key indicator of a borrower’s capacity to repay a loan. A higher ratio is generally associated with a higher risk that the borrower will have cash flow problems and may miss mortgage payments.

¹⁴According to CFPB, a qualified mortgage is a category of loans that have certain, more stable features that help make it more likely that a borrower is able to afford the loan. A lender must make a good-faith effort to determine that borrowers have the ability to repay a mortgage loan before it is made. This is known as the “ability-to-repay” rule. A creditor is presumed to have complied with the ability-to-repay requirements if the creditor makes a qualified mortgage loan.

¹⁵Mortgage Servicing Rules Under the Real Estate Settlement Procedures Act (Regulation X), 78 Fed. Reg. 10696 (Feb. 14, 2013); Mortgage Servicing Rules Under the Truth in Lending Act (Regulation Z), 78 Fed. Reg. 10902 (Feb. 14, 2013). The nine topics are: periodic billing statements; interest rate adjustment notices; prompt payment crediting and payoff statements; force-placed insurance; error resolution and information requests; general servicing policies, procedures, and requirements; early intervention with delinquent borrowers; continuity of contact with delinquent borrowers; and loss mitigation procedures.

have difficulty making their mortgage payments. The servicing rules also aim to ensure that borrowers are protected from harm in connection with the process of evaluating a borrower for a loss mitigation option or proceeding to foreclosure.¹⁶ The rules also address critical servicer practices relating to, among other things, correcting errors, imposing charges for force-placed insurance, crediting mortgage loan payments, and providing payoff statements.¹⁷

CFPB included a small servicer exemption from certain parts of the mortgage servicing rules.¹⁸ Generally, entities that service 5,000 or fewer mortgage loans, all of which they own or originated, are exempt, for example, from providing periodic statements. In general, entities that service one or more loans they neither originated nor own do not qualify as small servicers, even if they service 5,000 or fewer loans overall.

Regulatory Capital Requirements for MSRs.¹⁹ The Basel III framework addressed MSRs as part of its effort to improve the banking sector's ability to absorb shocks arising from financial and economic stress, whatever the source; improve risk management and governance; and

¹⁶For complete loss mitigation applications received more than 37 days before a foreclosure sale, servicers must evaluate borrowers for all available loss mitigation options and provide notice of decision; borrowers may appeal a denial of a loan modification so long as the borrower's complete loss mitigation application is received 90 days or more before a scheduled foreclosure sale. Servicers are restricted from dual-tracking, or simultaneously evaluating a borrower for a loss mitigation option while preparing to foreclose on the property.

¹⁷Force-placed insurance is hazard insurance obtained by a servicer on behalf of the owner or assignee of a mortgage loan that insures the property securing the loan.

¹⁸A small servicer is a servicer that (1) services 5,000 or fewer mortgage loans for all of which the servicer (or an affiliate) is the creditor or assignee; (2) is a Housing Finance Agency (as defined in 24 C.F.R. § 266.5); or (3) is a nonprofit entity that services 5,000 or fewer mortgage loans for all of which the servicer or an associated nonprofit entity is the creditor. 12 C.F.R. § 1026.41(e)(4)(ii).

¹⁹For the purposes of this report, regulatory capital requirements for U.S. banking organizations related to Basel III capital standards establish more restrictive capital definitions, higher risk-weighted assets, additional capital buffers, and higher requirements for minimum capital ratios.

strengthen banks' transparency and disclosures.²⁰ In 2013, the U.S. federal banking regulators adopted revised capital rules to implement many aspects of the Basel III capital framework and the Dodd-Frank Act that apply to banks, savings associations, and top-tier U.S. bank and savings and loan holding companies. The revised capital rules significantly changed the risk-based capital requirements for banks and bank holding companies, applied capital requirements to certain savings and loan companies, and introduced new leverage standards. These requirements include provisions related to MSRs that will be fully phased in by 2018, including:

- An amount equal to MSRs in excess of 10 percent of a bank's common equity tier 1 (CET1) capital is deducted from CET1 capital.²¹
- An amount equal to the sum of MSRs, certain deferred tax assets arising from temporary differences, and significant investment in the capital of unconsolidated financial institutions in the form of common stock in excess of 15 percent of CET1 capital is also deducted from tier 1 capital.
- MSRs that have not been deducted from CET1 capital are added to risk-weighted assets with a 100 percent risk-weight during the transition period and will be subject to a 250 percent risk-weight once the revised regulatory capital rule is fully phased-in.²²

In October 2015, NCUA also issued risk-based capital regulations.²³ However, unlike the banking regulators, which applied the MSR provisions to all supervised banks, NCUA exempted credit unions with

²⁰See Bank For International Settlements, *Basel III: A Global Regulatory Framework*; and *Basel Committee on Banking Supervision, Basel III: International Framework for Liquidity Risk Measurement, Standards and Monitoring* (Basel, Switzerland: December 2010, revised June 2011). The Basel framework was adopted in 2010 and revised in 2011 and 2013.

²¹Common equity tier 1 capital includes in part common shares and retained earnings. Tier 1 capital, in part is the sum of common equity tier 1 capital and additional tier 1 (which can include non-cumulative perpetual preferred shares).

²²Prior to the new regulations taking effect, MSRs were included in tier 1 capital up to 100 percent of their remaining unamortized book value (net of any related valuation allowances) reported on an institution's balance sheet or 90 percent of their fair value, whichever was lower. See 78 Fed. Reg. at 62069.

²³Risk-Based Capital, 80 Fed. Reg. 66626 (Oct. 29, 2015).

\$100 million or less in assets from its risk-based capital regulations.²⁴ Also, all MSRs have a 250 percent risk-weight under the NCUA rule. According to NCUA's final rule, the intent is to reduce the likelihood that a relatively small number of high-risk credit unions will exhaust their capital to cover their financial obligations and cause systemic losses under the Federal Credit Union Act, as amended. Under the act, all federally insured credit unions would have to pay through the National Credit Union Share Insurance Fund.²⁵ NCUA's risk-based capital rules will take effect on January 1, 2019.

Rule Development and Retrospective Review Processes

The CFPB and federal prudential regulators face several statutory requirements in the rule development process, including the Regulatory Flexibility Act (RFA), as amended by the Small Business Regulatory Enforcement Fairness Act of 1996 (SBREFA), and the Paperwork Reduction Act of 1995 (PRA). The RFA requires that federal agencies consider the impact on small entities of certain regulations they issue and, in some cases, alternatives to lessen the regulatory burden on small entities.²⁶ The PRA requires agencies to minimize the paperwork burden of their information collections and evaluate whether a proposed information collection is necessary for the proper performance of the functions of the agency.²⁷ In addition, when promulgating any rule that would have a significant economic impact on a substantial number of small entities, CFPB must convene a review panel to collect the advice and recommendations of small-entity representatives about the potential

²⁴NCUA defined small institutions in its October 2015 regulatory capital rules as those having \$100 million or less in assets. See 80 Fed. Reg. 66626.

²⁵The National Credit Union Share Insurance Fund is the federal fund created by Congress in 1970 to insure members' deposits in federally insured credit unions. Federally insured credit unions must maintain 1 percent of their deposits in the Share Insurance Fund. The purpose of the Share Insurance Fund's capitalization deposit is to cover losses in the credit union system.

²⁶Regulatory Flexibility Act, Pub. L. No. 96-354, 94 Stat. 1164 (1980) (codified as amended at 5 U.S.C. §§ 601-612). Under RFA, agencies, including financial regulators, generally must prepare a regulatory flexibility analysis in connection with certain proposed and final rules, unless the head of the issuing agency certifies that the proposed rule would not have a significant economic impact on a substantial number of small entities.

²⁷Paperwork Reduction Act of 1995, Pub. L. No. 104-13, 109 Stat. 163 (codified as amended at 44 U.S.C. §§ 3501-3520).

impacts of the proposed rule prior to publishing the required initial regulatory flexibility analysis.²⁸

Both CFPB and the banking regulators also have requirements to retrospectively review rules after rules are in effect. The Dodd-Frank Act requires CFPB to review its significant rules within 5 years of such rules taking effect.²⁹ CFPB is required to assess the effectiveness of the rules in meeting the purposes and objectives of Title X of the Dodd-Frank Act and the specific goals stated by the agency, which include ensuring that consumers receive timely and understandable information to make responsible decisions about financial transactions and that markets for consumer financial products and services are fair, transparent, and competitive. In addition, the federal banking regulators are required by the Economic Growth and Regulatory Paperwork Reduction Act of 1996 (EGRPRA) to review their regulations at least every 10 years to identify outdated, unnecessary, or unduly burdensome regulations, consider how to reduce regulatory burden on insured depository institutions, and eliminate unnecessary regulations as appropriate.³⁰ The report from the first EGRPRA review was submitted to Congress in 2007 and the second review is underway.³¹ The banking regulators have publicly stated they anticipate completing the current EGRPRA review by the end of 2016. NCUA conducts a voluntary review of its regulations on the same cycle and in a manner consistent with the EGRPRA review. Additionally, per NCUA's internal policies, NCUA conducts a review of all of its regulations every 3 years and produces a non-binding memorandum for its board with suggestions on rules that should be revised or streamlined.

²⁸See 5 U.S.C. § 609(b). We have work underway looking at CFPB's Small Business Review Panel process addressing the extent that CFPB considered small business inputs into its rulemaking and plan to issue a report later in 2016.

²⁹12 U.S.C. § 5512(d). Within 5 years of the effective date of each significant rule, CFPB must conduct an assessment of the rule and publish a report of its assessment.

³⁰Pub. L. No. 104-208, § 2222, 110 Stat. 3009, 3009-414 (codified at 12 U.S.C. § 3311).

³¹Joint Report to Congress, July 31, 2007; Economic Growth and Regulatory Paperwork Reduction Act, 72 Fed. Reg. 62036 (Nov. 1, 2007).

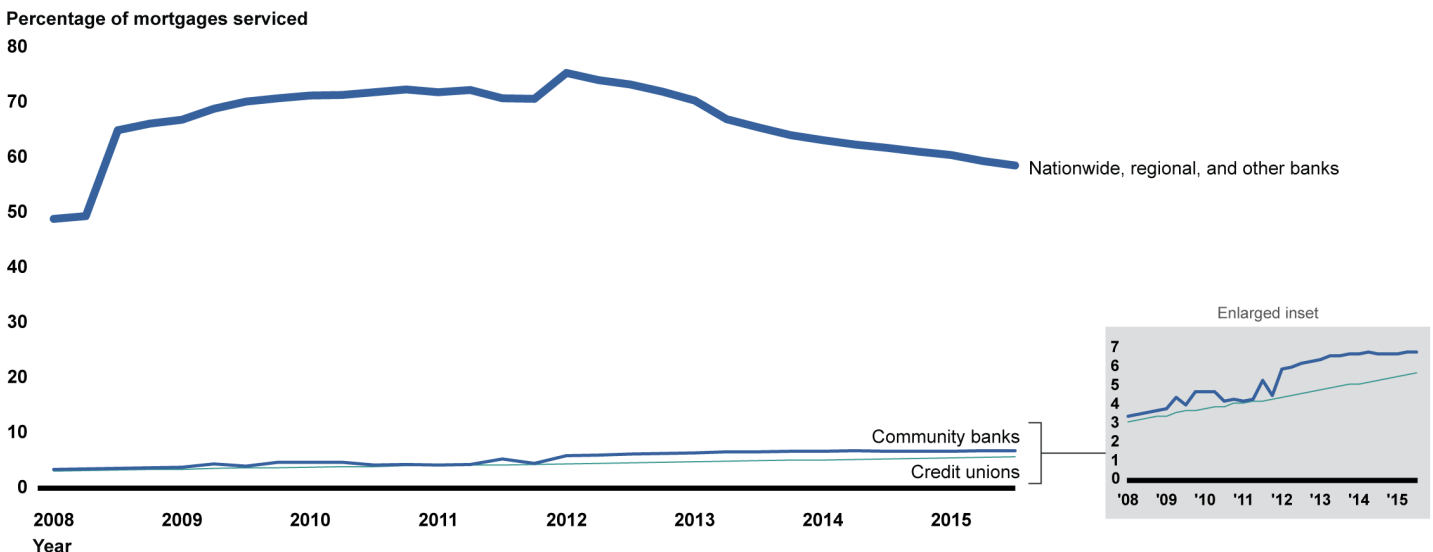
Community Lenders Continue to Service Mortgages as Regulatory Requirements Increase

Many of the representatives from 16 community lenders—9 community banks and 7 credit unions—that we interviewed noted that they have maintained their customer-focused business models and continued to service mortgages over the past 7 years. The total share of all mortgages serviced by community banks and credit unions has increased since 2008. Some representatives of community banks and credit unions told us that to manage their increased compliance costs of CFPB’s mortgage-related rules required under the Dodd-Frank Act, they made adjustments to certain business practices.

The Share of Mortgages Serviced by Community Lenders Has Increased Since 2008

Based on our analysis, the total share of all U.S. residential mortgages serviced by community lenders increased between 2008 and 2015. Specifically, between the first quarter of 2008 and the third quarter of 2015, the share of mortgages serviced by community banks increased from about 3.4 percent to about 6.8 percent, and the share serviced by credit unions rose from about 3.1 percent to about 5.7 percent (see fig. 2). The largest community banks and credit unions accounted for most of the growth in the share of servicing by community banks and credit unions. Over this period, the amount of residential mortgages outstanding fell from about \$11.3 trillion to about \$10 trillion.

Figure 2: Estimated Share of Residential Mortgages Serviced by Community Banks, Credit Unions, and Nationwide, Regional, and Other Banks, First Quarter 2008 through Third Quarter 2015 (percentage)



Source: GAO analysis of data from the Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation, the Federal Financial Institutions Examination Council, and the National Credit Union Administration. | GAO-16-448

Note: We used data on banks and credit unions that filed Call Reports for the period from the first quarter of 2008 through the third quarter of 2015. We identified community banks using Federal Deposit Insurance Corporation's Historical Community Banking Reference Data. Banks that are not community banks include nationwide and regional banks, internationally active banks, and specialty banks. We estimated the share of outstanding residential mortgages a bank services by adding the unpaid principal balance of residential mortgages held for investment, sale, or trading to the unpaid principal balance of residential mortgages serviced for others and dividing the result by total outstanding residential mortgages. We estimated the share of outstanding residential mortgages a credit union services by adding the amount of residential mortgages on its balance sheet to the amount of mortgages serviced for others and dividing the result by total outstanding residential mortgages. These estimates may overstate the fraction of residential mortgages a bank or credit union services because banks and credit unions may not service all of the residential mortgages on their balance sheet.

Nationwide, regional, and other banks continue to service more than half of the market. However, nonbank servicers—servicers that are not banks or credit unions and also are not affiliates of banks or credit unions—have increased their market presence. We previously estimated that the share of U.S. residential mortgages serviced by nonbank servicers increased from approximately 6.8 percent in the first quarter of 2012 to approximately 24.2 percent in the second quarter of 2015.³² At the same time, the share serviced by the largest nationwide, regional, and other banks decreased from about 75.4 percent to about 58.6 percent.

Many of the 16 community lenders we interviewed, which included representatives from 9 community banks and 7 credit unions, and several industry associations we spoke with told us that community banks and credit unions serviced mortgages held in portfolio or held MSRMs because these activities generated income and allowed them to maintain strong relationships with their customers. Some of these community lenders and industry associations noted that holding mortgage loans in portfolio and servicing these mortgage loans helped with overall profitability. For example, the servicing revenue can offset a reduction in income from originating loans when interest rates rise. Conversely, when interest rates decline, borrowers are more likely to prepay or refinance their mortgage loans, and servicing revenue may decline, while income from new mortgage loan originations might increase. Also, representatives at these institutions and two industry associations noted that servicing mortgages allowed them to offer customers other revenue-producing products and services. For example, representatives at one credit union told us that

³²See [GAO-16-278](#).

servicing mortgages provides it with the opportunity to develop borrowers into full members with checking and savings accounts and car loans.

In addition to revenue, many community lenders noted that they and their customers benefit from the close relationship maintained when these institutions service mortgages. Representatives at several institutions we interviewed emphasized that they were well positioned to work directly with customers experiencing hardship to mitigate losses. For example, representatives at one community bank told us that a customer who could not make a mortgage payment could meet directly with a bank representative to develop a payment plan. Customers of community lenders whose mortgages are serviced by these institutions may potentially also benefit by not being at risk of errors occurring during a transfer of servicing, a process that has resulted in violations of consumer protection laws and other regulations. As we noted in our March 2016 report on nonbank servicers, transfer errors can be especially harmful for borrowers in delinquency or in the middle of loss mitigation proceedings.³³ Representatives at several industry associations and community lenders that we interviewed for this report told us that community banks and credit unions preferred to retain MSRMs even if they sold the mortgages in the secondary market because they were able to maintain close customer contact should issues arise. A representative at one credit union told us that it had sometimes needed to step in on behalf of customers to help resolve issues, such as escrow errors, on mortgage loans they had sold without retaining the MSRMs.

³³See [GAO-16-278](#).

Many Community Lenders Reported Spending More in Response to Regulatory Requirements and Some Adjusted Business Activities, Potentially Affecting Customers

Many community lenders that we interviewed noted that they continued to service mortgages in their portfolio or to hold MSRMs on loans sold to the secondary market in spite of increased compliance costs of mortgage-related requirements resulting from new rules instituted pursuant to the Dodd-Frank Act.³⁴ These rules cover both origination and servicing of mortgage loans. They include new requirements, such as minimum underwriting standards for mortgage loan originators, disclosures to consumers about their mortgage loan obligations, and loss mitigation procedures. Some community lenders that we spoke with noted that they had increased staff, updated their data systems, or hired third parties to assist with compliance activities to meet CFPB's servicing rules. Similarly, in our December 2015 report on the effect of Dodd-Frank Act regulations on community banks and credit unions, we noted that representatives at community lenders we interviewed and CFPB stated that the compliance costs incurred by community lenders to implement new disclosures included costs of having to work with third-party vendors to update their loan origination and documentation system software.³⁵ In an industry survey of a nonprobability sample of banks in which the majority of respondents had less than \$1 billion in assets, over 80 percent of respondents noted that increased personnel costs and staff time allocated to compliance issues were the primary drivers of increased compliance

³⁴See Escrow Requirements Under the Truth in Lending Act (Regulation Z), 78 Fed. Reg. 4726 (Jan. 22, 2013); Ability-to-Repay and Qualified Mortgage Standards Under the Truth in Lending Act (Regulation Z), 78 Fed. Reg. 6408 (Jan. 30, 2013); Mortgage Servicing Rules Under the Real Estate Settlement Procedures Act (Regulation X), 78 Fed. Reg. 10696 (Feb. 14, 2013); Mortgage Servicing Rules Under the Truth in Lending Act (Regulation Z), 78 Fed. Reg. 10902 (Feb. 14, 2013).

³⁵GAO, *Dodd-Frank Regulations: Impacts on Community Banks, Credit Unions and Systemically Important Institutions*, GAO-16-169 (Washington, D.C.: Dec. 30, 2015).

costs. In addition, nearly 70 percent cited increased costs for third-party vendor services.³⁶

Some representatives at community banks and credit unions we spoke with commented that CFPB's exemptions for small servicers and creditors had been helpful to their businesses and customers. Several community lenders noted that CFPB's small servicer exemption, which excludes from certain parts of CFPB's mortgage servicing rules entities that service 5,000 or fewer mortgages, had been helpful in reducing some of their compliance requirements.³⁷ For example, representatives at one community bank noted that it was nearing the threshold and would have to create additional processes and install software, but would not intentionally limit its growth to qualify for the exemption. The community bank representatives also noted that the bank was preparing for the additional regulatory requirements by forming a mutual holding company with another bank to achieve greater economies of scale. Representatives at another bank noted that CFPB's small creditor exemption has allowed the bank to make loans that are considered qualified mortgages based on the bank's evaluation of a customer's debt

³⁶American Bankers Association, *22nd Annual ABA Real Estate Survey Report* (Washington D.C.: 2015). The 22nd Real Estate Lending Survey had the participation of 182 banks. The web survey was sent out to over 3,000 banks and elicited response from 182 banks for a response rate of 6 percent overall. The data were collected from March 4, 2015, to April 17, 2015, and in most cases report calendar year or year-end results. In other cases, data reflect current activities and expectations at the time of data collection. Of the survey participants, 68 percent of respondents were commercial banks and 32 percent were savings institutions. About 77 percent of the participating institutions had assets of less than \$1 billion. Because the survey relies on a nonprobability sample, the results cannot be used to make generalizations about all commercial banks and thrifts.

³⁷According to CFPB documentation, this definition covers substantially all of the community banks and credit unions that are involved in servicing mortgages. Although the rules exempt small servicers from certain provisions, they require, for example, all servicers to respond to written notices of errors received from borrowers, and with respect to loss mitigation, a small servicer is required to comply with two requirements: (1) a small servicer may not make the first notice or filing required for a foreclosure process unless a borrower is more than 120 days delinquent, and (2) a small servicer may not proceed to foreclosure judgment or order of sale, or conduct a foreclosure sale, if a borrower is performing pursuant to the terms of a loss mitigation agreement.

and income even though the customer did not meet the specific debt-to-income ratio required under CFPB's rule.³⁸

Some community lenders noted that to manage the increased compliance costs, they made adjustments to both loan origination and servicing business practices that could affect their customers' costs or choices. These adjustments included raising fees and interest rates and changing product offerings. Representatives at one credit union noted that while it had absorbed additional regulatory compliance costs into its general overhead expenses, it had to raise additional revenue to cover these additional expenses, such as increasing underwriting fees for mortgage applications. Several institutions noted that they no longer offered customers certain products because offering them would require additional compliance testing to meet regulatory requirements. For example, a representative at one community bank said that it no longer offers home equity lines of credit to its customers due to costs associated with complying with CFPB's rules related to increased disclosures to the customer.³⁹ Representatives at another community bank said it no longer offered bridge loans—short-term loans typically used when a consumer is

³⁸Under CFPB's Ability-to-Repay and Qualified Mortgage Standards Under the Truth in Lending Act (Regulation Z), 78 Fed. Reg. 6408 (Jan. 30, 2013) (ATR/QM rule) rule, which, as amended, became effective on January 10, 2014, generally, lenders making qualified mortgages must make a good-faith effort to determine that the borrower has the ability to repay the mortgage loan by documenting a borrower's income, assets, employment, credit history, and monthly expenses. The ATR/QM rule sets out several categories of qualified mortgage: general, temporary, and small creditor. Although small creditors must consider and verify the borrower's debt-to-income ratio, these loans are not subject to a specific debt-to-income ratio, such as the 43 percent or less determination under the general category. These loans must be made by small creditors and generally held in portfolio for at least 3 years. Small creditors are generally creditors that together with their affiliates have less than \$2 billion in assets (adjusted annually for inflation) and originated no more than 2,000 first-lien mortgage loans in the preceding year. Ability-to-Repay and Qualified Mortgage Standards Under the Truth in Lending Act (Regulation Z), 78 Fed. Reg. 35430, 35503 (June 12, 2013) and 80 Fed. Reg. 59944, 59968 (Oct. 2, 2015).

³⁹A home equity line of credit is a form of revolving credit in which a borrower's home serves as collateral. Many lenders set the credit limit on a home equity line by taking a percentage of the home's appraised value and subtracting from that the balance owed on the existing mortgage.

buying a new home before selling the consumer's existing home—to its customers.⁴⁰

Other community lenders told us that despite increased mortgage-related regulatory requirements under the Dodd-Frank Act, they ensured their customers' access to credit and maintained close customer contact. According to an FDIC report, community banks are often considered to be "relationship" bankers and tend to base credit decisions on local knowledge and long-term relationships with customers.⁴¹ Representatives at some community banks and credit unions we spoke with noted that because of their familiarity with customers, they were retaining mortgage loans in their portfolios that no longer met tighter credit restrictions in the secondary market under the Dodd-Frank Act.⁴² They explained that holding these mortgage loans allowed them more flexibility in their underwriting of these mortgage loans, which facilitated greater access to credit for their customers. Another community lender told us that although regulatory compliance costs necessitated having to outsource mortgage servicing to a third-party servicer, a credit union service organization, for its mortgage servicing activities, the credit union still speaks directly with

⁴⁰Usually secured by the existing home, a bridge loan provides financing for the new home (often in the form of the down payment) or mortgage payment assistance until the consumer can sell the existing home and secure permanent financing. Bridge loans normally carry higher interest rates, points, and fees than conventional mortgages, regardless of the consumer's creditworthiness.

⁴¹Community banks tend to focus on providing essential banking services in their local communities, and are often considered to be "relationship" bankers. This means that they have specialized knowledge of their local community and their customers. Because of this expertise, community banks tend to base credit decisions on local knowledge and nonstandard data obtained through long-term relationships and are less likely to rely on the models-based underwriting used by larger banks. See Benjamin R. Backup and Richard A. Brown, "Community Banks Remain Resilient Amid Industry Consolidation," *FDIC Quarterly*, vol. 8, no. 2, 2014 accessed on March 29, 2016 at https://www.fdic.gov/bank/analytical/quarterly/2014_vol8_2/article.pdf.

⁴²The enterprises generally purchase conforming loans, which are mortgage loans that meet certain criteria for size, features, and underwriting standards. The enterprises' underwriting includes assessments of measures of the credit risk of purchasing mortgages, such as borrower credit scores and debt-to-income ratios. For example, the enterprises have a debt-to-income ceiling of 45 percent.

borrowers who typically prefer to communicate with the mortgage loan officer because they have a pre-existing relationship.⁴³

Community Lenders Are Continuing Residential Mortgage Lending and Have Not Changed Their Customer-Focused Business Model

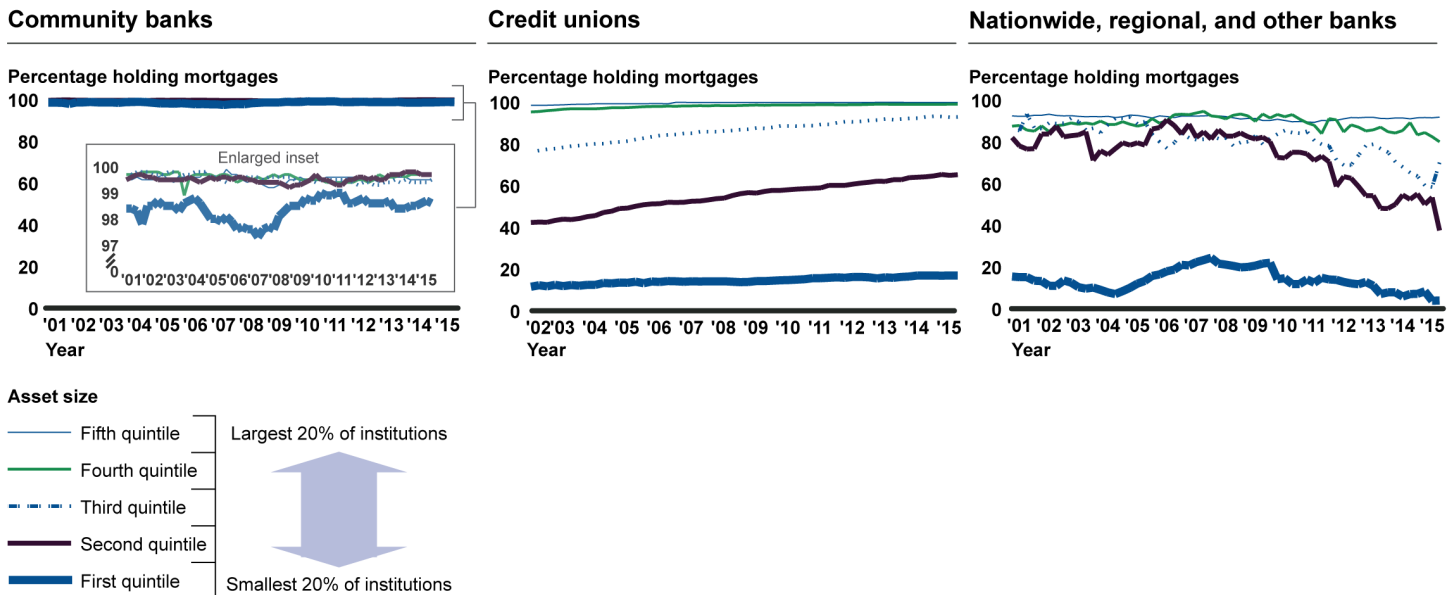
Although new regulations related to mortgage lending and servicing may increase compliance costs for community banks, our analysis suggests that these lenders generally appear to be participating in residential mortgage lending much as they have in the past. We found that for every quarter from the first quarter of 2001 through the third quarter of 2015, over 97 percent of community banks of all sizes had residential mortgages on their balance sheets (see fig. 3).⁴⁴ For most community banks with residential mortgages, these mortgages continued to average at least 10 percent of assets in their portfolio. Over the period from the first quarter of 2001 through the third quarter of 2015, median residential mortgages were 11 percent to 15 percent of assets for the smallest community banks and 16 percent to 20 percent of assets for larger community banks.⁴⁵ In addition, median residential mortgages as a percentage of assets have generally increased in the past couple of years for community banks of all sizes. Thus, community banks generally do not appear to be shifting their portfolios away from mortgage lending.

⁴³Credit union service organizations are entities that are owned by federally chartered or federally insured state-chartered credit unions and that are engaged primarily in providing products or services to credit unions or credit union members. See 12 C.F.R. § 712.1(d).

⁴⁴We used total assets to measure size and we divided all banks—community banks and nationwide, regional, and other banks—into five equal-sized groups, or quintiles, based on their size each quarter. The first quintile contained the smallest banks, the second quintile contained the next largest banks, and so on through the fifth quintile, which contained the largest banks. In the third quarter of 2015, the largest bank in the first quintile had assets of about \$73.9 million, the largest bank in the second quintile had assets of about \$138.5 million, the largest bank in the third quintile had assets of about \$250.6 million, the largest bank in the fourth quintile had assets of about \$545.1 million, and the largest bank in the fifth quintile had assets of about \$2 trillion. There were 1,187, 1,248, 1,243, 1,234, and 899 community banks in the first, second, third, fourth, and fifth quintiles, respectively.

⁴⁵We calculated residential mortgages as a percentage of assets for every bank and then calculated the median value of residential mortgages as a percentage of assets for community banks in each size group, where the median value is the middle or 50th percentile value when the values are ordered from smallest to largest.

Figure 3: Percentage of Community Banks, Credit Unions, and Nationwide, Regional, and Other Banks with Residential Mortgages on their Balance Sheets by Size, First Quarter 2001 through Third Quarter 2015 (percentage)



Source: GAO analysis of data from the Federal Deposit Insurance Corporation, the Federal Financial Institutions Examination Council, and the National Credit Union Administration. | GAO-16-448

Note: We used data on banks that filed Call Reports for the period from the first quarter of 2001 through the third quarter of 2015 and on credit unions that filed Call Reports from the second quarter of 2002 through the third quarter of 2015. We assigned banks to groups each quarter using quintiles based on the distribution of their total assets, where the first quintile contains the smallest 20 percent of banks, the second group contains the next largest 20 percent of banks, and so on through the fifth quintile, which contains the largest 20 percent of banks. We identified community banks using Federal Deposit Insurance Corporation’s Historical Community Banking Reference Data. Banks that are not community banks include nationwide and regional banks, internationally active banks, and specialty banks. We also assigned credit unions to groups each quarter using quintiles based on the distribution of their total assets. Banks that hold residential mortgages are those that hold residential mortgages for investment, sale, or trading. Credit unions that hold residential mortgages are those that hold first lien residential mortgages or any other real estate loan or line of credit, which typically includes second mortgages, and home equity lines of credit, but may also include some member business loans secured by subordinate real estate liens. Thus, our calculations may overstate the fraction of credit unions with residential mortgages.

Similarly, the largest nationwide, regional, and other banks (those in the fifth quintile) generally do not appear to be changing the extent to which they participate in mortgage lending. Over the period from the first quarter of 2001 through the third quarter of 2015, over 89 percent of the largest nationwide, regional, and other banks had residential mortgages on their

balance sheets.⁴⁶ Among those institutions that had residential mortgages, median residential mortgages were between 13 percent and 16 percent of their assets. In contrast, the percentage of smaller nationwide, regional, and other banks (those in the first, second, third, and fourth quintiles) with residential mortgages on their balance sheet has generally decreased over the period.

Finally, our analysis suggests that credit unions are generally participating in residential mortgage lending at least as much as they have in the past. Throughout the period from the first quarter of 2002 through the third quarter of 2015, larger credit unions were more likely to have residential mortgages than smaller credit unions.⁴⁷ However, for credit unions of all sizes, the percentage with residential mortgages increased. Among credit unions with residential mortgages, larger credit unions typically had more residential mortgages as a percentage of assets than small credit unions. Median residential mortgages ranged from 6 percent to 10 percent of assets for the smallest credit unions, and up to 24 percent to 35 percent of assets for the largest credit unions. While median residential mortgages as a percentage of assets have decreased for the smallest credit unions in recent quarters, they have remained constant or increased in recent quarters for larger credit unions. Like community banks, credit unions generally do not appear to be shifting their portfolios away from mortgage lending, with the possible exception of the smallest institutions.

⁴⁶There were 77, 16, 20, 30, and 364 nationwide, regional, and other banks in the first, second, third, fourth, and fifth quintiles, respectively.

⁴⁷As we did with banks, we used total assets to measure size and we divided credit unions into quintiles based on their size each quarter. In the third quarter of 2015, the largest credit union in the first quintile had assets of about \$5.1 million, the largest credit union in the second quintile had assets of about \$16.3 million, the largest credit union in the third quintile had assets of about \$42.3 million, the largest credit union in the fourth quintile had assets of about \$139.3 million, and the largest credit union in the fifth quintile had assets of about \$72 billion. There were 1,244 credit unions in the first quintile and 1,243 credit unions in the second, third, fourth, and fifth quintiles.

New Capital Treatment of Mortgage Servicing Rights Likely Will Not Affect Many Community Banks and Credit Unions

Our analysis suggests that the capital treatment of MSRMs would not likely have a material effect on most community banks because they generally did not have large concentrations of MSRMs. Most community banks we interviewed confirmed that they did not need to make changes to their capital because of these rules, but those with large concentrations of MSRMs were considering changes to their capital. We also do not expect the capital treatment of MSRMs to affect most applicable credit unions based on our analysis and discussions with NCUA and credit unions.

Most Community Banks and Credit Unions Hold Limited MSRMs and Have Sufficient Capital to Cover Them

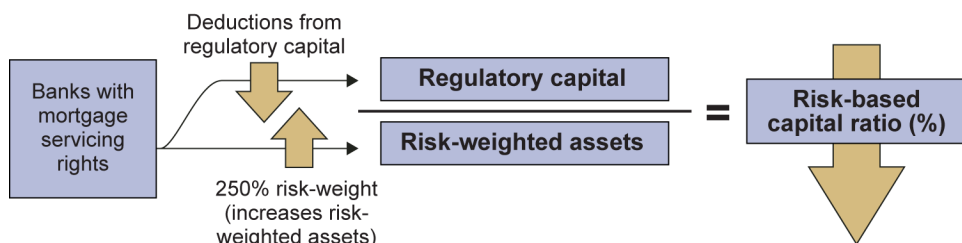
Regardless of type or size, banks with large concentrations of MSRMs may need to raise capital as a result of the new risk-based capital treatment of MSRMs, but our analysis and most community banks we spoke with confirmed that these new rules were currently not an issue for them.⁴⁸ As stated earlier, new banking requirements being phased in by January 1, 2018, include requiring any amount of MSRMs above 10 percent of a firm's common equity tier 1 (CET1) capital to be deducted from CET1 capital. In addition, MSRMs, adjusted for amounts deducted from CET1 capital, are currently assigned a 100 percent risk weighting, which means that every \$1 in these MSRMs adds \$1 to risk-weighted assets. When the new requirements are fully phased in, any MSRMs not deducted from CET1 capital will be assigned a 250 percent risk weighting, which means every \$1 in these MSRMs will add \$2.50 to risk-weighted assets (see fig. 4).⁴⁹ Some banks may have to increase CET1 capital to ensure that their ratios of CET1 capital to risk-weighted assets remain above the required

⁴⁸Prudential regulators' capital rules implementing Basel III include provisions related to MSRMs that are to be fully phased in by 2018 and that will affect banks' regulatory capital as well as their risk-weighted assets. For a more complete discussion of Basel III, see GAO, *Bank Capital Reforms: Initial Effects of Basel III on Capital, Credit, and International Competitiveness*, [GAO-15-67](#) (Washington, D.C.: Nov. 20, 2014).

⁴⁹Any amount of MSRMs, certain deferred tax assets arising from temporary differences, and significant investments in the capital of unconsolidated financial institutions in the form of common stock (collectively, "threshold items") above 15 percent of a firm's CET1 capital must be deducted from CET1 capital. Starting January 1, 2018, any amount of the threshold items that is not deducted from CET1 capital will be risk weighted at 250 percent.

minimum.⁵⁰ Those banks that need to raise capital could face increased funding costs that they could, in turn, pass on to consumers through increased cost or reduced availability of credit. However, most community banks subject to the capital requirements we spoke with said that they did not expect to need to make changes to their capital because they did not hold large concentrations of MSR and had sufficient capital.

Figure 4: Mortgage Servicing Rights and Risk-Based Capital Ratios



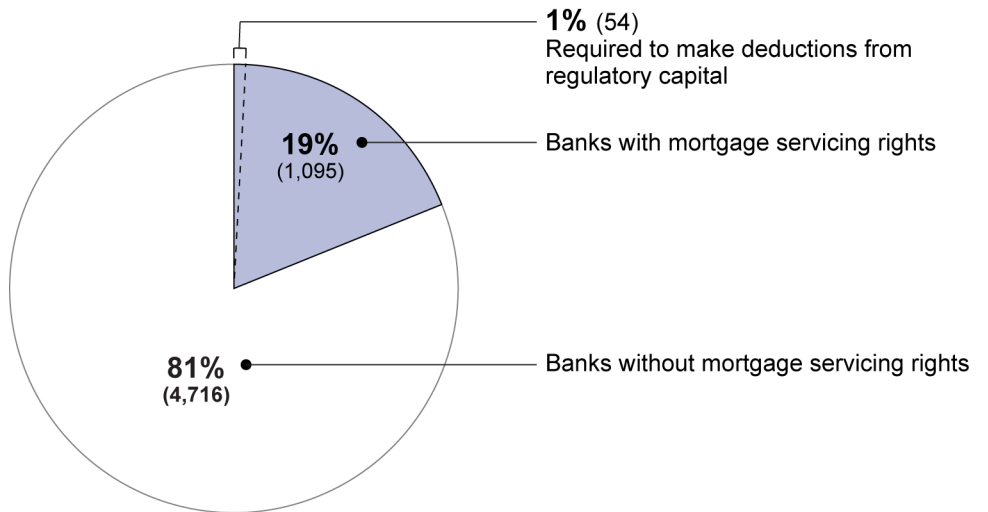
Source: GAO analysis of Federal Deposit Insurance Corporation information on risk-based capital rules. | GAO-16-448

Note: Mortgage servicing rights (MSRs) up to 10 percent of common equity tier 1 (CET1) capital will receive a 250 percent risk weight when the new risk-based capital requirements are fully phased in. The remaining MSRs are not included in risk-weighted assets.

Based on our analysis, the capital treatment of MSRs likely would not have a material effect on most community banks because they generally did not have large concentrations of MSRs. Data on banks' holdings of MSRs for the period from the first quarter of 2001 through the third quarter of 2015 showed that larger community banks were more likely to have MSRs than smaller community banks and that more community banks of all sizes were holding MSRs in 2015 than in 2001. However, these assets were typically a small fraction of total assets. Specifically, the median value of MSRs as a percentage of total assets has remained at less than 1 percent in each quarter since the first quarter of 2001. Additionally, our analysis showed that about 19 percent of community banks held MSRs and about 1 percent made MSR-related deductions from capital due to the amount of these assets they held as of the third quarter of 2015 (see fig. 5).

⁵⁰Two banking regulators noted that a bank's capital is a function of its overall risk profile and not just the MSR amount.

Figure 5: Community Banks' Capital Treatment of Mortgage Servicing Rights, 2015Q3



Source: GAO analysis of data from the Federal Deposit Insurance Corporation and the Federal Financial Institutions Examination Council. | GAO-16-448

Note: Estimates of the percentage of community banks holding mortgage servicing rights (MSR) and the percentage making deductions from their capital because of their MSR holdings are based on Call Report data from the third quarter of 2015.

Most community banks we interviewed confirmed that they did not need to make changes to their capital because of these rules, but those with large concentrations of MSRs were considering changes to their capital. Institutions with large concentrations of MSRs may choose to raise additional capital or sell MSRs to meet required minimum capital amounts, depending on banks' holdings of other types of assets. Most representatives of community banks said that regulatory changes to the capital treatment of MSRs did not require them to sell MSRs or raise additional capital. For example, two banks stated that they were not close to the 10 percent threshold and one of the banks noted that their total MSR values were small relative to their total capital levels.

However, two other banks we interviewed with large concentrations of MSRs (one of which was a midsized regional bank) stated that they would likely be affected by the MSR provisions in the risk-based capital rules and were considering options to raise capital levels by selling MSRs or other ways. For example, one community bank with less than \$1 billion in assets told us that MSRs equaled 47 percent of total capital and that under the new risk-based capital rules the bank would need to make a \$12 million deduction from regulatory capital. The bank officials stated that the rules would prevent the bank from growing as much as it would

like. Another midsized regional bank that services mortgages it originates and purchases MSR from others said that it was evaluating how to reduce its MSR holdings, which currently equaled about 22 percent of total capital, without affecting revenue. Bank officials said that the 10 percent threshold and the 250 percent risk weight were hindrances. One industry survey on capital treatment of MSRs found that about 5 percent of respondents had sold MSRs in the past year, and 14 percent were contemplating selling MSRs due to new regulatory requirements or capital treatment of MSRs compared to 11 percent in 2013.⁵¹

Further, our analysis of data on the ratios of CET1, tier 1, and total capital to risk-weighted assets for the first three quarters of 2015 showed that almost all community banks in every size group met or exceeded regulatory minimums in each of the first three quarters of 2015. Over 99 percent of community banks of all sizes had CET1 capital ratios greater than or equal to the minimum required ratio of 4.5 percent plus a 2.5 percent buffer in all three quarters. Similarly, over 98 percent had tier 1 capital ratios greater than or equal to the minimum of 6.0 percent plus a 2.5 percent buffer, and over 97 percent had a total capital ratio greater than or equal to the minimum of 8.0 percent plus a 2.5 percent buffer. Finally, we found that while most community banks of all sizes had capital ratios well in excess of the regulatory minimums, small community banks typically had higher capital ratios than larger community banks (see table 2).

⁵¹The American Bankers Association's The 22nd Real Estate Lending Survey had the participation of 182 banks. The data were collected from March 4, 2015, to April 17, 2015, and in most cases reports calendar year or year-end results. In other cases, data reflect current activities and expectations at the time of data collection. Of the survey participants, 68 percent of respondents were commercial banks and 32 percent were savings institutions. About 77 percent of the participating institutions had assets of less than \$1 billion.

Table 2: Median Risk-Based Capital Ratios for Community Banks by Size and Required Minimum Capital Ratios, Third Quarter 2015

	Median for first quintile (smallest)	Median for second quintile	Median for third quintile	Median for fourth quintile	Median for fifth quintile (largest)	Required minimum plus 2.5 percent buffer
CET1 capital ratio	18.3	16.4	15.2	14.5	13.1	7.0
Tier 1 capital ratio	18.3	16.4	15.2	14.5	13.2	8.5
Total capital ratio	19.5	17.6	16.4	15.6	14.3	10.5

Source: GAO analysis of data from the Federal Deposit Insurance Corporation and Federal Financial International Examinations Council. | GAO-16-448

Note: We used data on common equity tier 1 (CET1), tier 1, and total risk-based capital ratios reported by banks that filed Call Reports for the third quarter of 2015. We assigned banks to groups based on the distribution of their total assets. We divided banks into quintiles, where the first quintile contains the smallest 20 percent of banks, the second group contains the next largest 20 percent of banks, and so on through the fifth quintile, which contains the largest 20 percent of banks. We identified community banks using the Federal Deposit Insurance Corporation's Historical Community Banking Reference Data.

We estimated how much banks' CET1 capital ratios might increase if they replaced their MSR with an asset such as U.S. Treasury securities that could be held in any amount without reducing capital and that was not included in risk-weighted assets. Analysis of Call Report data on capital and risk-weighted assets for 2015 suggests that replacing MSR with U.S. Treasury securities would have little effect on the capital ratios of most community banks with MSR. If a community bank replaced its MSR with U.S. Treasury securities, which do not require a deduction in CET1 capital and which have a zero percent risk-weight, then its CET1 capital would increase and its risk-weighted assets would fall, all else being equal. However, our estimates suggest that for most community banks with MSR, the increase in the CET1 capital ratio would be less than 1 percentage point.⁵²

NCUA finalized its risk-based capital rule on October 29, 2015. The rule applies to credit unions regulated by NCUA with assets over \$100 million

⁵²Our analysis has limitations and should be interpreted with caution. Specifically, available data do not include all of the amounts required to calculate how the CET1 capital ratio would change if banks with MSR replaced their MSR with U.S. Treasury securities, so we made assumptions that likely caused us to overestimate that change. In addition, the new risk-based capital requirements are not fully phased-in, and banks may not have fully adjusted to them, so these results may not be indicative of the extent to which banks will be affected by the new risk-based capital requirements in the future. See appendix I for more details of our analysis.

and assigns a 250 percent risk-weight to MSRs.⁵³ Based on discussions with NCUA and market participants, we also do not expect the capital treatment of MSRs to affect most applicable credit unions. NCUA officials told us that it did not expect the risk-based capital standards to prevent credit unions from holding MSRs. Some credit unions we spoke with also stated that NCUA's risk-based capital rule was not likely to affect them. One credit union told us that it was well capitalized and that the risk-based capital rule would likely not affect it. This credit union has an MSR value of about \$1.2 million, which equates to 3 percent of its capital. Another credit union stated that it would not need to do anything differently, and another did not see the risk-based capital threshold as an issue. NCUA's risk-based capital rules will take effect on January 1, 2019.

Changes in banks' funding costs and costs to consumers as a result of the regulatory capital rules are likely to be modest. Since most community banks likely would not have to increase capital because of these rules, costs to consumers similarly are not expected to increase. However, banks that do have to increase capital may need to cover increased funding costs, which could affect the cost and availability of credit to consumers.⁵⁴ We found in a 2015 report on risk-based capital rules that raising capital to cover any capital shortfalls associated with new minimum capital requirements, including provisions related to MSRs, would likely have a modest effect on the cost and availability of credit to consumers.⁵⁵ First, in that report we estimated that the total amount of capital that banks would need to raise to meet the new minimum capital ratios would likely amount to less than 1 percent of total assets. Second, our report noted that although funding costs for banks that increase equity capital to meet new minimum capital requirements could increase, we estimated that the change would likely be small, generally about 0.3 percentage points or less. Finally, we estimated in our 2015 report that any increases in loan rates consumers experience due to increases in funding costs also are likely to be small in part because banks may be limited in the extent to which they can raise lending rates. In part, banks respond to changes in their funding costs in several ways. Banks that

⁵³Risk-Based Capital, 80 Fed. Reg. 66626 (Oct. 29, 2015).

⁵⁴Equity funding is generally more expensive than debt funding, so increasing capital will cause overall funding costs to increase, all else being equal.

⁵⁵See [GAO-15-67](#).

need to raise capital may cover their increased funding costs by raising loan rates, shifting lending activity to lower-risk borrowers, and increasing efficiency.

Community Lenders Are Likely to Remain Minor Participants in MSR Sales, Which Can Be Influenced by Several Factors

Our analyses of loan transfer data show that smaller banks and credit unions maintained a relatively small level of participation in the MSR market. Between 2010 and the first half of 2015, MSRs representing the right to service totaled approximately \$2.1 trillion worth of unpaid principal balance were sold via bulk sales associated with Fannie Mae, Freddie Mac, and Ginnie Mae mortgage pools.⁵⁶ Over this period, banks and credit unions with assets of less than \$10 billion represented about 13 percent of MSR sales and 4 percent of MSR purchases as a portion of the unpaid principal balance within Freddie Mac and Ginnie Mae loan pools.⁵⁷ Nonbanks accounted for most of the remaining purchases of MSRs backed by mortgages in Freddie Mac and Ginnie Mae mortgage pools over the period, and large banks and credit unions—those with more than \$10 billion in assets—and nonbanks had roughly equal proportions of sales. See appendix II for more information about MSR purchases and sales.

Market participants, regulators, and mortgage brokers commented that recent trends in the market for MSRs have been influenced by a number of factors, including volatility in the value of MSRs, compliance risk, interest rates and prepayments, and regulatory capital requirements. For example, volatility in the value of MSRs makes pricing this asset difficult, which could affect banks' decisions about retaining or selling MSRs. One regulator explained that MSR values could be volatile because of assumptions about their perceived value and noted that it advised institutions with MSR concentrations to use a third-party valuator to test these assumptions. One mortgage broker we spoke with explained that the fair value of MSRs is difficult to determine using observable measures

⁵⁶The MSR associated with these loans often is measured as a function of the unpaid principal balance. In addition to bulk sales, MSRs may be sold through co-issue transactions in which the MSR is sold concurrently with the sale of the associated mortgage into the secondary market. According to one government-sponsored enterprise, these types of arrangements are more common among nonbanks than banks.

⁵⁷Data provided by Fannie Mae did not allow GAO to perform a comparable analysis to Freddie Mac and Ginnie Mae.

such as market prices or models. Also, fair value can be difficult to determine due to the lack of comparable active trades. According to one bank, it prefers not to manage the volatility associated with MSR values, given the need to reflect MSR values on the balance sheet.⁵⁸ The bank sells its loans along with the servicing. The bank official added that he does not believe the bank's ability to retain customers is negatively affected by its decision not to perform mortgage servicing. However, some community lenders we spoke with did not see volatility in MSR values as a concern for their business operations. These lenders viewed MSR values as a part of their broader business decisions (e.g., selling loans into the secondary market and retaining servicing) rather than as assets to be monitored closely.

Increased concerns about compliance risk, especially uncertainty associated with new regulations, could potentially decrease the value of, and thus demand for, MSR values. Failure to comply with CFPB's new consumer financial laws related to originating and servicing mortgages can result in possible losses from litigation and enforcement actions. One government-sponsored enterprise expressed concern that regulatory costs and penalties might push competent servicers out of the market. One mortgage broker stated that aside from operational risks, there has been a cumulative effect of recent regulations on servicers, which includes increased costs, as well as uncertainty about future costs. In terms of compliance, a regional bank we spoke with stated that although the regulations brought more clarity around requirements and consistency in how bank staffs interact with customers, the resources needed to keep up with the regulations had the biggest effect on the bank. For example, the bank officials stated that in 2013 the bank prepared a project management document to map out the implementation and systems requirements needed to comply with all the new regulations. The bank set up committees around a number of regulatory changes. FHA officials shared this concern, stating that they had heard servicers complaining about uncertainty associated with the enforcement of regulations and penalties they might face. These officials believed that servicers needed more time to adapt their systems to existing regulations and increase their

⁵⁸Under the fair value method of accounting, changes in the value of MSR values must be reflected on the bank's balance sheet immediately.

capacity to implement changes before additional regulations were developed.

Interest rates and prepayments may also affect the value of MSR. Rising interest rates can reduce homebuyers' willingness or ability to finance a real estate loan. Higher rates could negatively affect both the volume of loan originations and profitability. Rising interest rates and lower prepayments can result in increased value of MSR portfolios. In contrast, when interest rates fall, prepayment speeds increase as borrowers refinance their mortgages, causing a decline in MSR's value, because MSRs associated with prepaid loans are eliminated.⁵⁹ Though MSR values are expected to decrease when prepayments increase, MSR holders may be able to recapture lost revenue if they have a mortgage origination business. While servicing is seen as a business hedge that offsets fluctuations in mortgage lending, changes in MSR values may occur more rapidly than changes in the rates of mortgage originations.⁶⁰ In addition, a market development or policy change that encourages or discourages borrowers to refinance their loans could impact prepayments and thus the value of MSRs. For instance, in a January 2015 press release, the Department of Housing and Urban Development announced that the Federal Housing Administration would reduce annual insurance premiums that new borrowers pay by half a percent. This reduction in insurance premiums would lower the cost of owning a home and may contribute to a decrease in mortgage prepayments. According to the press release, the action is projected to save more than 2 million FHA homeowners an average of \$900 annually and spur 250,000 new homebuyers to purchase their first homes over the next 3 years.

Finally, a few market participants we spoke with attributed some sales by large banks to nonbanks in the MSR market to the anticipated changes to the treatment of MSRs in risk-based capital requirements. For example, officials from one government-sponsored entity explained that in some

⁵⁹One community bank with a relatively large concentration of MSRs related to commercial real estate said that they had prepayment penalties built into the terms of their loans that could protect investors from prepayments.

⁶⁰Servicing offsets fluctuations in mortgage lending. On the production side (i.e., originations), margins and volumes are highest when interest rates are low. Conversely, on the servicing side, MSRs gain value when interest rates rise (i.e., number of prepayments expected to decrease).

cases banks with high levels of MSR on their balance sheet may be selling their MSR to nonbank subsidiaries but would continue to service the loan as a servicer. Additionally, one mortgage broker told us that regulatory capital requirements motivated some banks to sell MSR, but added that for a majority of banks, regulatory capital requirements are a non-issue. As mentioned earlier, two banks with large concentrations of MSR stated that they expected to be impacted by mortgage servicing regulatory capital rules in the future. These banks were considering options to adjust their required capital levels, such as selling MSR, but they noted that selling MSR could limit growth and decrease their overall profitability.

Regulators Estimated Impacts of New Rules Using Public Input and Data Analysis, but CFPB's Plans for Reviewing Rules Have Limitations

CFPB used several methods to estimate the impact of its mortgage servicing rules prior to finalizing them in 2013, and banking regulators incorporated changes to the treatment of MSR when they estimated the overall impact of new regulatory capital rules in 2013. Both CFPB and banking regulators have begun preparing to retrospectively review these rules. However, CFPB's plans are limited because the agency has not finalized an approach for retrospectively reviewing its mortgage servicing rules. Banking regulators have incorporated the regulatory capital rules as part of a retrospective review of all their rules—which is required every 10 years—although the review will be complete before these rules are fully phased in.

CFPB Used Multiple Methods to Obtain Public Comments and Estimate Impact Prior to Issuing Final Mortgage Servicing Rules

CFPB used several methods to estimate the impact of its mortgage servicing rules prior to finalizing the rules in 2013. For example, prior to issuing proposed rules, CFPB officials met with representatives of small entities that would be subject to the rule to obtain input about CFPB's proposals on mortgage servicing requirements. As noted earlier, when promulgating any rule that would have a significant economic impact on a substantial number of small entities, CFPB must convene a review panel to collect the advice and recommendations of small entity representatives prior to issuing a proposed rule.⁶¹ The panel received comments from representatives of 16 small entities, including 5 banks and 5 credit unions. These representatives' comments played a significant role in persuading

⁶¹See 5 U.S.C. § 609(b).

CFPB to propose exempting smaller servicers from certain mortgage-servicing requirements, agency officials said.

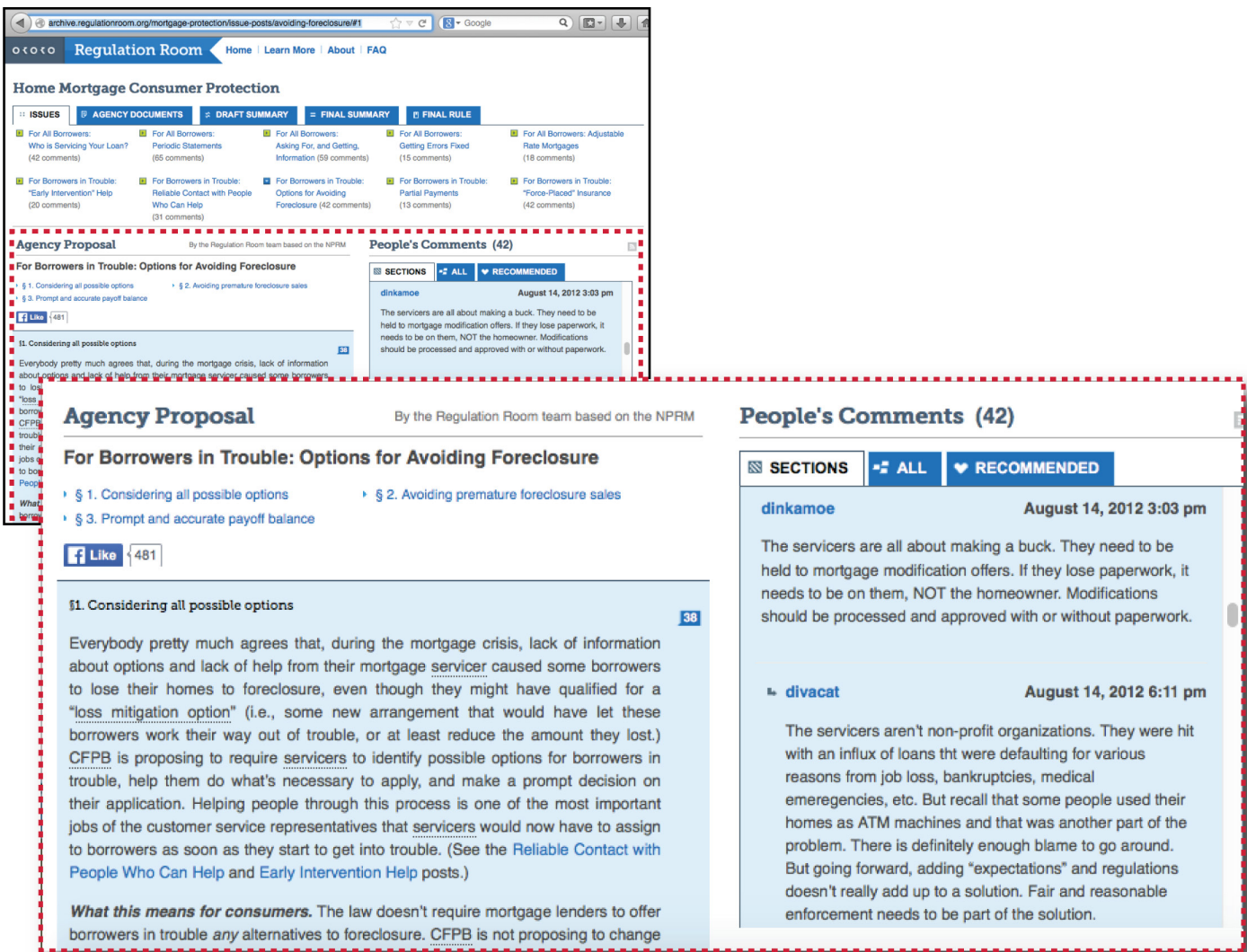
CFPB also sought comments on its proposed rule both by issuing a formal request for public comment in the Federal Register and seeking public input via an interactive website called “Regulation Room” operated by Cornell University’s eRulemaking Initiative. Agency officials said they hoped the Regulation Room would allow CFPB to obtain a broader range of perspectives than those coming from a formal request for comment.⁶² CFPB received 347 comments from the Regulation Room on questions on topics such as options for avoiding foreclosure and getting errors fixed (see fig. 6). CFPB officials said comments on the proposed rules prompted the agency to scrutinize the definition of small servicers and ultimately led to CFPB expanding eligibility for the small-servicer exemption in the final rule. The final rule expanded the small-servicer exemption to institutions with up to 5,000 mortgages, up from the proposed rule’s 1,000-loan threshold. Specifically, public comments prompted the agency to analyze state-level averages on loan balances rather than the national averages used for the proposed rule.⁶³ This change in the underlying data from national to state-specific information led CFPB to determine that a 5,000-loan threshold would better meet the agency’s goal of having the small-servicer exemption apply to nearly all banks with \$2 billion or less in assets, officials said.⁶⁴

⁶²The eRulemaking Initiative describes the Regulation Room website as a pilot project that provides an online environment for people and groups to learn about, discuss, and react to selected regulations proposed by federal agencies. It expands the types of public input available to agencies in the rulemaking process, while serving as a teaching and research platform.

⁶³Using state-specific data on average loan balance—rather than national data—changed the results of the agency’s analysis of the proportion of banks that would qualify for the exemption, agency officials said.

⁶⁴In the preamble to its final rule, CFPB said two bank trade associations and the Small Business Administration recommended an exemption threshold of up to 10,000 loans. CFPB determined such a threshold was too high because it would also exempt 50 percent of banks and credit unions with more than \$2 billion in assets, including 20 percent of those institutions with more than \$10 billion in assets. See Mortgage Servicing Rules Under the Truth in Lending Act (Regulation Z), 78 Fed. Reg. 10902, 10981 (Feb. 14, 2013).

Figure 6: Sample Public Comments from the “Regulation Room” on CFPB’s Proposed Mortgage Servicing Rule



Source: Cornell eRulemaking Initiative. | GAO-16-448

CFPB identified the exemption for small servicers as an element in mitigating compliance costs for small banks and credit unions. The agency said estimates showed that 99 percent of banks and credit unions with less than \$1 billion in assets—and 98 percent of banks with \$2 billion or less in assets—would be eligible for the small servicer exemption that would eliminate the requirements to comply with many components of the mortgage-servicing rules. For example, small servicers are not required to engage in certain types of early intervention with delinquent borrowers,

such as providing a written description of loss-mitigation options within 45 days of a borrower's delinquency.⁶⁵

In addition to its approaches to obtain public comment, CFPB conducted several required analyses before issuing the final rule, including an analysis of the potential impact on small banks and credit unions, as required by the RFA.⁶⁶ CFPB also considered the potential costs and benefits for consumers and all banks and credit unions, as required by the Dodd-Frank Act.⁶⁷ For both analyses, CFPB described potential impacts but did not give a specific financial estimate of expected impacts, citing data limitations as a barrier to quantifying impacts. For example, CFPB cited data gaps in servicers' costs for vendor services, such as the one-time and ongoing costs that vendors were likely to charge for creating and sending periodic statements to mortgage holders and new disclosures to customers for the reset of adjustable-rate mortgages. CFPB officials said they were hindered in trying to estimate these costs because many vendor contracts required banks to keep terms of their agreements confidential.⁶⁸ CFPB also cited limitations in trying to quantify the benefits for customers of additional disclosures and other provisions of the mortgage servicing rules, noting that the rules were designed to

⁶⁵Examples of requirements that small servicers must follow include prohibitions on making the first notice or filing required for a foreclosure process unless a borrower is more than 120 days delinquent and proceeding to foreclosure judgment or order of sale, or conducting a foreclosure sale, if a borrower is performing under the terms of a loss-mitigation agreement.

⁶⁶CFPB defined small banks and credit unions using a definition prepared by the Small Business Administration as those with \$175 million or less in assets.

⁶⁷See Pub. L. No. 111-203, § 1022(b)(2)(A), 124 Stat. 1376, 1980 (2010) (codified at 12 U.S.C. § 5512(b)(2)(A)). We reviewed CFPB's Dodd-Frank Act section 1022(b)(2) analysis conducted in connection with the final rule, available at Mortgage Servicing Rules Under the Truth in Lending Act (Regulation Z), 78 Fed. Reg. 10902, 10978 (Feb. 14, 2013), but did not assess the quality of the analysis.

⁶⁸In the preamble to its final rule, CFPB discussed some elements that the agency believed would likely mitigate the total costs for regulated entities, even if those costs could not be quantified. For example, CFPB created sample disclosure forms that banks could directly adopt and allows coupon books to be provided in lieu of monthly statements for certain fixed-rate mortgages. See Mortgage Servicing Rules Under the Real Estate Settlement Procedures Act (Regulation X), 78 Fed. Reg. 10696, 10697 (Feb. 14, 2013). In addition, the one-time costs incurred by any single vendor for producing each new form were likely to be spread among a large number of servicers, which would mitigate the cost to each servicer.

address a failure of the servicing market that exists because consumers dissatisfied with their mortgage servicer cannot easily change servicers. Benefits are especially hard to quantify when rule changes are intended to address market failures, CFPB said in the preamble to its final rule.⁶⁹ The agency noted that none of the public commenters proposed methods for addressing this measurement limitation.

CFPB also analyzed the expected information collection burden on affected entities—an analysis required under the Paperwork Reduction Act of 1995—and produced a specific financial estimate. CFPB’s estimates show that the mortgage servicing regulations would lead servicers regulated by CFPB to spend an average of about 91 hours annually and an additional 4 hours in one-time efforts to comply with the information requirements associated with the rules. In addition, servicers would spend an average of about \$900 each year for vendor services and another \$700 in one-time costs to comply.⁷⁰

⁶⁹Specifically, CFPB stated: “These potential benefits and costs, and these impacts, however, are not generally susceptible to particularized or definitive calculation in connection with this rule. The incidence and scope of such potential benefits and costs, and such impacts, will be influenced very substantially by economic cycles, market developments, and business and consumer choices, which are substantially independent from adoption of the rule. No commenter has advanced data or methodology that it claims would enable precise calculation of these benefits, costs, or impacts. Moreover, the potential benefits of the rule on consumers and covered persons in creating market changes that are anticipated to address market failures are especially hard to quantify.” Mortgage Servicing Rules Under the Real Estate Settlement Procedures Act (Regulation X), 78 Fed. Reg. 10696, 10844 (Feb. 14, 2013).

⁷⁰Costs likely would not be spread evenly, however. For example, banks that do not service mortgages on adjustable-rate loans would not need to address the new requirements for providing notice for adjustable-rate loans. CFPB officials said estimates of vendor costs were based on information obtained from larger banks. The information could not be extrapolated to its Regulatory Flexibility Analysis estimates pertaining to the costs for small banks to hire vendors, CFPB officials said.

Banking Regulators Included Changes in the Treatment of MSRs in Their Impact Estimates Prior to Issuing New Regulatory Capital Rules

Banking regulators included the planned changes to the treatment of MSRs when estimating the impact of the regulatory capital rules issued in 2013. However, they did not specifically isolate the impact only from the changes to the treatment of MSRs. Regulators' impact estimates were prepared to comply with the RFA, which requires that regulators describe the impact of significant rules on small entities.⁷¹ Although the RFA requires that regulators describe the overall rule's impact on small businesses, it does not require regulators to isolate the impact of specific parts of an overall rule.

Each of the three prudential banking regulators—the Federal Reserve, FDIC, and OCC—included the 10 percent threshold on MSRs when estimating the number of banks that would not conform with the new regulatory capital rules and the amount of their capital shortfall. NCUA, which issued a regulatory capital rule for credit unions in October 2015 that exempted credit unions with less than \$100 million in assets, did not conduct a Regulatory Flexibility Act analysis on small credit unions because it concluded that its rule would not have a material effect on those institutions.⁷² Although each banking regulator included the 10 percent MSR deduction threshold, only one of the three regulators—FDIC—also included the change in MSR risk weights in its estimation model.⁷³ Officials from the Federal Reserve said that they did not incorporate the impact of increased risk weights in their analyses because the change in MSRs' risk weights would not have a meaningful effect on the regulatory capital rules' impact on small banks. OCC officials told us omitting the impact of the 250 percent risk weight was an oversight. When

⁷¹The banking regulators defined small banks and credit unions using a definition prepared by the Small Business Administration as those with \$500 million or less in assets.

⁷²See Risk-Based Capital, 80 Fed. Reg. 66626, 66704 (Oct. 29, 2015). Small credit unions, under NCUA's definition, see 12 C.F.R. § 702.103(b), were those with \$50 million or less in assets, and therefore NCUA's regulatory capital rules would not impact small credit unions, NCUA concluded. When an agency determines and certifies that a regulation would not have a significant economic impact on a substantial number of small entities, a Regulatory Flexibility Act analysis is not required. See 5 U.S.C. § 605(b).

⁷³As we previously noted, banking regulators changed risk weights for MSRs from 100 percent to 250 percent for MSRs that are included in the calculation of CET1 capital under the risk-based capital framework, though these requirements are being phased in through 2018. FDIC did not isolate the impact of changing risk weights when it estimated the overall rule's impact on small businesses.

OCC included the 250 percent risk weight in a re-analysis of the same bank data after our inquiry, OCC officials found that the number of banks needing capital would not change. In their analyses, the three banking regulators estimated that a combined 124 small banks would need to raise about \$408 million by the end of 2018, when the regulatory capital rules are fully phased in.⁷⁴ Banking regulators estimated that the 124 banks would face costs of about \$2.2 million per year collectively—or less than \$18,000 per bank, on average—to raise this \$408 million by converting debt to equity.⁷⁵ Banking regulators did not identify how much of these costs would be attributable to MSRs specifically, but the \$2.2 million per year represents an upper limit of the maximum possible impact related to the MSR provisions.⁷⁶

In a separate analysis, the banking regulators estimated that small banks as a group would spend about \$242 million—about \$43,000 per bank—to comply with the rule. For some banks, this would represent a significant impact to the bank, regulators found. For example, OCC estimated that compliance costs would represent a significant impact for about 19

⁷⁴Regulators' estimates were distributed as follows: The Federal Reserve estimated 9 small banks would need to raise a total of about \$11 million in additional capital; OCC found that 41 small banks would need to raise a total of about \$164 million; and FDIC projected that 74 small banks would need to raise a total of about \$233 million. See 78 Fed. Reg. at 62153 (Federal Reserve) and 62154-55 (OCC); 79 Fed. Reg. at 20757 (FDIC). When the OCC re-estimated impact to include the 250 percent risk weight provision, OCC officials determined that the amount of capital needing to be raised was still about \$164 million. Federal Reserve officials re-estimated impact to include the 250 percent risk weight provision using updated data from June 30, 2015, and found that 2 small, state member banks would not meet the minimum capital ratio. The total capital shortfall for these 2 banks would be \$8.6 million. (The Federal Reserve's analysis that was published with the rule used data on state member banks from March 31, 2013.)

⁷⁵The costs calculated were based on the loss of tax benefits associated with converting debt to equity. Converting debt to equity would be one possible method for complying with regulatory capital requirements.

⁷⁶It is not possible to determine from the banking regulators' analyses whether the projected capital shortfall was the result of changes in the capital treatment of MSRs or from some other aspect of the regulatory capital rule. Banks could fall short of the new regulatory capital standards even if MSRs represented far less than 10 percent of their common equity tier 1 capital, or even if they had no MSRs at all. Conversely, banks could meet the various regulatory requirements for common equity tier 1 capital, overall tier 1 capital, and total regulatory capital even if their MSR holdings exceeded 10 percent of their common equity tier 1 capital if they had sufficient cushion from other types of regulatory assets.

percent of small banks it supervised.⁷⁷ In addition, banking regulators estimated the expected burden associated with additional information collection—as required by the Paperwork Reduction Act—and estimated that banks would not face any added monetary costs associated with information collection.

Banking regulators obtained public input about the MSR provisions of the regulatory capital rules during the rulemaking but said they did not revise their proposed changes to the treatment of MSRs as a result. In the preamble to the final rule, they noted that some commenters advocated different approaches both for the threshold for including MSRs in CET1 capital and for risk weights assigned to MSRs. Regulators noted in the final rule that MSRs have long been fully or partially excluded from regulatory capital because of the high level of uncertainty regarding the ability of banking organizations to realize value from these assets. Officials from the three banking regulators also stated that their organizations, which had participated in the international Basel III agreement, wanted to adhere to the principles described in the agreement.

CFPB's Plans for Conducting Retrospective Reviews of the Mortgage Servicing Rules Are Incomplete, and Banking Regulators' Reviews of Capital Rules Are Ongoing

CFPB's plans for retrospectively reviewing its mortgage servicing rules are incomplete, as the agency has not finalized its planned approach. This review is required under the Dodd-Frank Act within 5 years from the effective date of significant rules, which would be January 2019 for the mortgage servicing rules.⁷⁸ The Dodd-Frank Act requires CFPB to publish a report assessing the effectiveness of significant rules in meeting the goals described by CFPB and the purposes and objectives of Title X of the Dodd-Frank Act. CFPB staff prepared a preliminary planning document in May 2015, but as of April 2016, the agency's plan is not final. The Dodd-Frank Act also requires CFPB to invite public comments on recommendations to modify significant rules before the report is

⁷⁷In its published rules, OCC and FDIC calculated that compliance costs would have a significant impact when the compliance costs exceeded 2.5 percent of banks' total noninterest expense or 5 percent of banks' annual salaries and employee benefits. The Federal Reserve did not publish a calculation in its final rule for the number of banks that would be significantly impacted by estimated compliance costs.

⁷⁸See Pub. L. No. 111-203, § 1022(d), 124 Stat. 1376, 1984-85 (2010) (codified at 12 U.S.C. § 5512(d)).

published.⁷⁹ CFPB has not determined how the agency will obtain public comment on any recommendations.

OMB has provided guidance to independent agencies about effective approaches for retrospectively reviewing existing rules. While not required for independent agencies such as CFPB, OMB guidance suggests that plans for retrospective reviews of regulations should specify the outcomes and methodologies—such as the specific metrics, baselines, and analytical methods—that agencies plan to use in their reviews.⁸⁰ CFPB’s plan has identified some potential methodologies for measuring outcomes, but the agency has not determined which specific approaches it will employ. OMB also has cited the benefits of providing members of the public with an opportunity to comment on draft plans because they may have useful information and perspectives for improving the quality of agencies’ planned approaches for retrospective reviews.⁸¹ In addition, we found in 2014 that public input from informed stakeholders such as regulated entities and policy advocacy groups could be useful in evaluating regulatory reforms.⁸² CFPB officials said that as of April 2016 the agency had not decided whether to incorporate an opportunity for public input into its methodologies for analyzing the rules.

CFPB officials said a specific plan for reviewing the mortgage servicing rules had not been completed because it was too soon to identify the relevant data and because the agency wanted the flexibility to design the

⁷⁹See § 1022(d)(3), 124 Stat. at 1985 (codified at 12 U.S.C. § 5512(d)(3)).

⁸⁰OMB memorandums M-11-10 and M-11-28 provide guidance to independent agencies—and OMB Circular A-4 provides guidance to all federal agencies—related to creating an overall process for reviewing existing rules. However, we believe the same guidance is relevant when agencies are required to review specific rules, as CFPB is required to do under section 1022(d) of the Dodd-Frank Act. For example, we found in 2007 that if agencies fail to plan for how they will measure the performance of their regulations, and what data they will need to do so, they may continue to be limited in their ability to assess the effects of their regulations. See GAO, *Reexamining Regulations: Opportunities Exist to Improve Effectiveness and Transparency of Retrospective Reviews*, [GAO-07-791](#) (Washington, D.C.: July 16, 2007).

⁸¹See OMB Memorandum M-11-19 and the related Executive Order 13563.

⁸²GAO, *Reexamining Regulations: Agencies Often Made Regulatory Changes, but Could Strengthen Linkages to Performance Goals*, [GAO-14-268](#) (Washington, D.C.: Apr. 11, 2014).

most effective method to analyze the rules. In addition, they noted there were trade-offs associated with seeking public input at the planning stage because it may add time and cost to the review. However, we found in a 2007 report on retrospective reviews that agencies are better prepared to perform effective reviews if they identify potential sources of data and the measures that would be needed to assess effectiveness of the rules.⁸³ For example, soliciting input during the planning process could better prepare CFPB by clarifying the feasibility of certain methodologies that the agency is considering, and potentially save time and agency resources if public input suggests that certain potential methodologies would not be feasible. Further delay in finalizing a plan may preclude an effective review if the agency were to forgo complex or time-consuming methodologies due to time constraints.⁸⁴

Banking regulators reported two separate ongoing efforts to assess the potential impacts of the regulatory capital rule, including the provisions related to MSRs. The first effort is part of a review process established under EGRPRA, which requires that banking regulators review all of their rules at least once every 10 years.⁸⁵ However, the current EGRPRA review is to be completed later this year—before the regulatory capital rules are fully in effect in 2019—and therefore banking regulators may not be able to determine the full impact from the EGRPRA review. The sources for public input as part of the EGRPRA process include six

⁸³See [GAO-07-791](#). We recommended that OMB officials provide guidance to regulatory agencies to consider, during the promulgation of certain new rules, how to measure the performance of the regulation—including how and when they will collect, analyze, and report the data needed to conduct a retrospective review. OMB implemented the recommendation by providing such guidance in 2011.

⁸⁴Agency officials do not have direct experience with how long this review process will take because the agency has not yet completed any of these required 5-year retrospective reviews of significant rules. The agency was still developing its overall plan for conducting these reviews in February 2016. The first such review is expected to be completed in late 2018 for a rule addressing electronic remittance transactions, CFPB officials said.

⁸⁵The first EGRPRA review was completed in 2007. If banking regulators complete the current review in 2016 as planned, the next review would be required to be completed by 2026. NCUA also is conducting a similar review of its regulations. Although NCUA is not technically required to participate in the EGRPRA review process, it is conducting its own review “in keeping with the spirit of the law,” according to NCUA. NCUA has participated along with the banking regulators in the EGRPRA planning process but has developed its own regulatory categories that are comparable with those developed by the banking regulators.

separate outreach sessions at various locations across the United States that allow the public to provide input during panel discussions.⁸⁶ The regulatory capital rules were not part of the original information request for the current EGRPRA process because these rules had been recently promulgated and have not been fully phased in, but banking regulators added the regulatory capital rules to the list of those eligible for comment. Regulators also included the regulatory capital rules in one of its requests for written public comments as part of the EGRPRA process. The second effort is a separate study of the capital requirements for MSRs that was mandated by the Consolidated Appropriations Act, 2016. The law requires federal banking regulators and NCUA to study such issues as the impact of the MSR provisions on competition in the mortgage servicing business and on services to mortgage customers, as well as the risk to banking institutions in holding MSRs.⁸⁷ As of June 8, 2016, the study had not been issued.

In addition to these planned reviews, banking regulators said that they often conducted other informal reviews as needed to evaluate the effectiveness of rules. For example, OCC officials said the agency considers the need to revise regulations based on other factors such as changes in the broader economy and feedback from financial institutions during agency outreach and interactions with OCC supervisory staff. Federal Reserve representatives said the agency periodically reviews its existing rules to see if they need to be updated, though there is no formal schedule for conducting such a review. FDIC officials also cited its bank examination process and other outreach sessions with a community bank advisory committee as other mechanisms for obtaining public input that could lead to additional review of existing rules. In 2007, we reported that agencies often found their discretionary reviews to be more productive and likely to generate action than mandatory reviews.⁸⁸ However, we found that the mandatory EGRPRA process was an exception, with the

⁸⁶Between December 2014 and December 2015, EGRPRA outreach meetings were held in Los Angeles, Dallas, Boston, Kansas City, Chicago, and Washington, D.C.

⁸⁷Pub. L. No. 114-113, Div. E, tit. VI, § 634(b), 129 Stat. 2242, 2471 (2015). The report is required to be submitted to the Senate Committee on Banking, Housing, and Urban Affairs and the House Committee on Financial Services not later than 180 days after enactment of the appropriations act, or June 2016.

⁸⁸See [GAO-07-791](#).

first EGRPRA cycle ending in 2006 generating at least four regulatory changes and more than 180 legislative proposals for regulatory relief.

Conclusions

Mortgage servicing is a substantial business for many community banks and credit unions, and the value of their MSRs exceeded \$3 billion as of September 30, 2015. The Dodd-Frank Act requires that CFPB review significant rules to evaluate the rules' effectiveness, seek public input on recommendations for modifying significant rules, and report on those review findings no later than 5 years after the rules take effect. For the mortgage servicing rules, this review must be completed by January 2019. To allow CFPB to understand the rules' impact, including for consumers and the market for consumer financial products, these retrospective reviews must be carefully planned to specify the metrics, baselines, and analytical methods to be used. We and OMB have found that these elements, as well as seeking public input before finalizing plans, can benefit the overall quality of a review. However, as of April 2016, CFPB had not finalized a plan for reviewing the mortgage-servicing rules, including what methodologies to use and when to seek public input. Without a completed plan, CFPB risks not having enough time to perform an effective review.

Recommendation for Executive Action

To enhance the effectiveness of preparations for conducting a retrospective review of its mortgage servicing regulations, the Director of the Consumer Financial Protection Bureau should complete a plan to identify the outcomes CFPB will examine to measure the effects of the regulations, including the specific metrics, baselines, and analytical methods to be used. For example, in developing such a plan, CFPB could seek public input for information and perspectives to improve the quality of its review through feedback on available data or improvements on proposed methodologies.

Agency Comments and Our Evaluation

We provided a draft of this report for review and comment to CFPB; HUD, including the Federal Housing Administration and Ginnie Mae; FDIC; Federal Housing Finance Agency (FHFA), including Fannie Mae and Freddie Mac; the Federal Reserve; NCUA; OCC; the Department of Veterans Affairs (VA); and the U.S. Department of Agriculture (USDA). CFPB and NCUA provided written comments, which we have reprinted in appendixes III and IV, respectively. FDIC; FHFA, including Freddie Mac; the Federal Reserve; OCC; and VA also provided technical comments which we have incorporated, as appropriate. HUD, including the Federal

Housing Administration and Ginnie Mae; and USDA did not provide comments.

In its written comments, CFPB agreed to take steps to complete its plan for conducting a retrospective review of the mortgage servicing rules. While CFPB has developed a preliminary planning document that identifies potential methodologies for measuring outcomes, the agency stated that it is continuing to work on its plan. Specifically, CFPB intends to refine the scope and relative emphases of the assessment, the outcomes the assessment will likely focus on, potential ways to measure outcomes, the qualitative and quantitative information used, and the cost to gather such information. CFPB also stated that it intends to finalize its plan by incorporating each of these elements, while ensuring that sufficient time is allotted to make modifications should potential improvements or identified costs necessitate revisions.

In its written comments, NCUA stated that it agrees with the report's conclusions as they relate to NCUA and the credit union industry. In particular, NCUA agrees with the conclusion that NCUA's capital treatment of MSR is unlikely to affect most credit unions.

As agreed with your office, unless you publicly announce the contents of this report earlier, we plan no further distribution until 30 days from the report date. At that time, we will send copies of this report to CFPB, HUD, FDIC, FHFA, the Federal Reserve, NCUA, OCC, VA, and USDA and other interested parties. In addition, the report will be available at no charge on the GAO website at <http://www.gao.gov>.

If you or your staff have any questions about this report, please contact me at (202) 512-8678 or sciremj@gao.gov. Contact points for our Offices of Congressional Relations and Public Affairs may be found on the last page of this report. Key contributors to this report are listed in appendix V.

Sincerely yours,

A handwritten signature in black ink, appearing to read "Mathew J. Sciré". The signature is fluid and cursive, with a long horizontal stroke extending to the right.

Mathew J. Sciré
Director, Financial Markets and Community Investment

Appendix I: Objectives, Scope, and Methodology

The objectives of our report were to examine (1) community lenders' participation in the mortgage servicing market and potential effects of the Bureau of Consumer Financial Protection (commonly known as the Consumer Financial Protection Bureau or CFPB) mortgage servicing rules on those lenders, (2) potential effects of the risk-based capital treatment of mortgage servicing rights (MSR) on decisions about holding or selling MSRs, and (3) the process regulators used to estimate the impact of regulations addressing mortgage servicing requirements and the risk-based capital treatment of MSRs.

To describe the extent to which banks and credit unions are engaged in mortgage lending and servicing activities, we used data from the Board of Governors of the Federal Reserve System (Federal Reserve), the Federal Deposit Insurance Corporation (FDIC), the Federal Financial Institutions Examination Council (FFIEC), and the National Credit Union Administration (NCUA). For banks, we used quarterly data on banks that filed Call Reports (forms FFIEC 031 and 041) for the period from the first quarter of 2001 through the third quarter of 2015. We divided banks into groups based on their size and type.

- *Size.* We used total assets to measure size and we divided banks into five equal-sized groups, or quintiles, based on their size each quarter. The first quintile contained the smallest banks, the second quintile contained the next largest banks, and so on through the fifth quintile, which contained the largest banks.
- *Type.* We assigned banks to groups based on whether or not they were a community bank—that is, we classified a bank as a community bank if it was identified as such in FDIC's Historical Community Bank Reference Data dataset. In this dataset, a bank is a community bank if it is part of a banking organization that has loans or core deposits, a foreign assets-to-total assets ratio less than 10 percent, and has less than 50 percent of assets in certain specialty banks, including credit card specialists, consumer nonbank banks, industrial loan companies, trust companies, and bankers' banks. (Consumer nonbank banks are financial institutions with limited charters that can make commercial loans or take deposits, but not both.) In addition, the banking organization must either have total assets less than an indexed asset size threshold or total assets greater than the indexed asset size threshold, a loan-to-assets ratio greater than 33 percent, a core deposits-to-assets ratio greater than 50 percent, more than one office but no more than the indexed maximum number of offices, offices in less than three large metropolitan statistical areas, offices in less than four states, and no single office with deposits greater than the indexed

maximum branch deposit size. (The asset size threshold is indexed to equal \$250 million in 1985 and \$1 billion in 2010. The maximum number of offices is indexed to equal 40 in 1985 and 75 in 2010. The maximum branch deposit size is indexed to equal \$1.25 billion in 1985 and \$5 billion in 2010.)

In the third quarter of 2015, the largest bank in the first quintile had assets of about \$73.9 million, the largest bank in the second quintile had assets of about \$138.5 million, the largest bank in the third quintile had assets of about \$250.6 million, the largest bank in the fourth quintile had assets of about \$545.1 million, and the largest bank in the fifth quintile had assets of about \$2 trillion. There were 1,187, 1,248, 1,243, 1,234 and 899 community banks in the first, second, third, fourth, and fifth quintiles, respectively. There were 77, 16, 20, 30, and 364 nationwide, regional, and other banks in the first, second, third, fourth, and fifth quintiles, respectively.

To describe the extent to which banks of different sizes and types in our sample were engaged in mortgage lending and servicing activities, we determined whether each bank held residential mortgages for investment, sale, or trading and had MSR. ¹ In addition, we calculated residential mortgages held for investment, sale, or trading as a percentage of total assets and MSR as a percentage of total assets. Finally, we estimated the fraction of all outstanding residential mortgages that each bank serviced by adding the unpaid principal balance of residential mortgages held for investment, sale, or trading to the unpaid principal balance of residential mortgages serviced for others and divided the result by total outstanding residential mortgages. This calculation may overstate the fraction of residential mortgages banks service because the institutions may not service all mortgages held for investment, sale, or trading. We summarized the values of these variables for each quarter for each group of banks. Our analysis of banks has limitations and should be interpreted with caution. In particular, some new regulations related to mortgage lending and servicing have only recently become effective or are not yet fully implemented, and banks may not have fully adjusted to them. As a result, current trends may not be indicative of the extent to which banks participate in residential mortgage lending and servicing in the future. We

¹MSRs may include mortgage servicing assets that are commercial mortgage servicing assets or other nonresidential mortgage servicing assets.

assessed the data we used for this analysis by reviewing relevant documentation and by electronically testing the variables for missing values, invalid values, and outliers. We found them to be sufficiently reliable for the purpose of conducting our analysis.

For credit unions, we used quarterly data on those that filed Call Reports (form NCUA 5300) for the period from the second quarter of 2002 through the third quarter of 2015. We divided the credit unions in our sample into groups based on their size. As we did with banks, we used total assets to measure size and we divided credit unions into quintiles each quarter based on their size. Again, the first quintile contained the smallest credit unions, the second quintile contained the next largest credit unions, and so on through the fifth quintile, which contained the largest credit unions. In the third quarter of 2015, the largest credit union in the first quintile had assets of about \$5.1 million, the largest credit union in the second quintile had assets of about \$16.3 million, the largest credit union in the third quintile had assets of about \$42.3 million, the largest credit union in the fourth quintile had assets of about \$139.3 million, and the largest credit union in the fifth quintile had assets of about \$72 billion. There were 1,244 credit unions in the first quintile and 1,243 credit unions in the second, third, fourth, and fifth quintiles.

To describe the extent to which credit unions of different sizes were engaged in mortgage lending and servicing activities, we determined whether a credit union held residential mortgages on its balance sheet, and had MSR. In addition, we calculated residential mortgages as a percentage of total assets and MSR as a percentage of total assets. Finally, we estimated the fraction of all outstanding residential mortgages that each credit union serviced by adding residential mortgages on the balance sheet to mortgages serviced for others and dividing the result by total outstanding residential mortgages. As with community banks, this calculation may overstate the fraction of residential mortgages serviced because the institutions may not service all of the residential mortgages on their balance sheet and because mortgages serviced for others may include commercial mortgages. We summarized the values of these variables for each quarter for each group of credit unions. As with our analysis of banks, our analysis of credit unions has limitations. In particular, current trends may not be indicative of the extent to which credit unions participate in residential mortgage lending and servicing in the future. We assessed the data we used for this analysis by reviewing relevant documentation and electronically testing the variables for missing values, invalid values, and outliers. We found the data to be sufficiently reliable for the purpose of conducting our analysis.

To understand the regulatory framework for mortgage servicers, we reviewed applicable laws and regulations and relevant literature on community banks' and credit unions' participation in the mortgage servicing market. As part of this review, we selected academic studies and research by industry organizations, federal agencies, GAO, and others since the 2007–2009 financial crisis on the mortgage servicing market that focused on the role of community banks and credit unions. In particular, to examine the potential impacts of compliance with mortgage-related regulatory requirements we reviewed the 2010 Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act) and the Consumer Financial Protection Bureau (CFPB) mortgage servicing rules established in accordance with the act. We focused our analysis on the final rules issued pursuant to the Dodd-Frank Act that became effective since 2013. For each rule, we reviewed the *Federal Register* release of the final rule document.

To assess the potential effects on banks of the capital treatment of MSRs under the prudential regulators' capital rules implementing Basel III, we used data from FDIC and FFIEC. We used quarterly data on banks that filed Call Reports (forms FFIEC 031 and 041) for the first three quarters of 2015. We divided banks into groups based on their size and type, as described previously. We collected data on banks' common equity tier 1 (CET1), tier 1, and total capital ratios and we determined whether the ratios met or exceeded regulatory minimum amounts, with and without a capital conservation buffer. We also counted the number of banks with MSRs that did and did not make deductions from CET1 capital based on the amount of MSRs on their balance sheets. Finally, for banks with MSRs, we estimated what the CET1 capital ratio would be if banks replaced MSRs with U.S. Treasury securities or some other asset with a zero risk weight that is not deducted from CET1 (hereafter, the counterfactual CET1 capital ratio). The CET1 capital ratio is the ratio of CET1 capital to risk-weighted assets. Under the prudential regulators' capital rules implementing Basel III, replacing MSRs with U.S. Treasury securities would affect both CET1 capital (the numerator) and risk-weighted assets (the denominator). We took the following steps to estimate the numerator and the denominator of our counterfactual CET1 ratio:

- To estimate the numerator, we assumed that if banks replaced their MSRs with U.S. Treasury securities, then they would make no MSR-related deductions from CET1 capital. Thus, we estimated the numerator by adding a bank's MSR-related deductions back to its CET1 capital. Our assumption leads us to overestimate counterfactual

CET1 capital because replacing MSR with U.S. Treasury securities may not cause all MSR-related deductions to fall to zero. However, we make this assumption because we cannot calculate exactly how all of the MSR-related deductions would change with available data.

- To estimate the denominator, we assumed that if banks replaced their MSR with U.S. Treasury securities, their risk-weighted assets would decrease by an amount equal to 10 percent of their CET1 capital, risk-weighted at 100 percent during the transition period and at 250 percent fully phased in. Under the prudential regulators' capital rules implementing Basel III, banks include in their risk-weighted assets the amount of MSR adjusted for deductions from CET1. At most this amount is equal to 10 percent of CET1. We note that this assumption leads us to underestimate counterfactual risk-weighted assets because the amount of MSR adjusted for deductions from CET1 and thus added to risk-weighted assets may be equal to less than 10 percent of CET1. We made this assumption because we cannot calculate exactly how risk-weighted assets would change with available data.

Our analysis has limitations and should be interpreted with caution. In particular, the new risk-based capital requirements are not fully phased-in, and banks may not have fully adjusted to them. As a result, current trends may not be indicative of the extent to which banks will be affected by the new risk-based capital requirements in the future. We assessed the data we used for this analysis by reviewing relevant documentation and by electronically testing the variables for missing values, invalid values, and outliers. We determined that the data were sufficiently reliable for the purpose of estimating the potential effects on banks of the capital treatment of MSR under the prudential regulators' capital rules implementing Basel III.

To determine community banks' and credit unions' participation in sales or purchases of MSR in the secondary market, we analyzed data on transfers of mortgage servicing rights obtained from Fannie Mae, Freddie Mac, and Ginnie Mae for the period from 2010 through the second quarter of 2015. We used these data to determine the amount of MSR (unpaid principal balance) associated with mortgage pools which were sold via bulk sales by banks, credit unions, and nonbank entities. We also determined the percentage of transfers between entity types such as bank to bank and bank to nonbank transactions, and dollar volume of these transfers. Additionally, we calculated the number of loans associated with transfers by year. We assessed the reliability of these data for this purpose by electronically testing the variables for missing

values, invalid values, and outliers. We determined the data to be sufficiently reliable for the purpose of determining community banks' and credit unions' participation in sales or purchases of MSRs.

To determine the process regulators used to estimate the impact of regulations addressing mortgage servicing requirements and the risk-based capital treatment of MSRs, we reviewed the final and proposed rules to understand the results of regulators' estimates of the rules' impacts. We also reviewed other agency documentation, including CFPB's report summarizing the results of a small business review panel. We also interviewed CFPB officials and banking regulators to understand their approaches for estimating the impact of the regulations before the final rules were issued.

To examine the extent to which CFPB and banking regulators have plans in place to monitor and assess the effects of new rules related to mortgage servicing or MSRs, we identified and reviewed requirements and guidance relating to agencies' efforts to monitor and assess regulations (criteria). We also identified and reviewed Office of Management and Budget memorandums and related Executive Orders related to agencies' efforts to conduct retrospective reviews. To evaluate CFPB's approach toward these retrospective reviews, we also reviewed provisions of the Dodd-Frank Act that require CFPB to assess its significant rules and CFPB's planning documents for conducting these assessments. In addition, to evaluate banking regulators' approach toward the assessment of the regulatory capital rules that include changes to MSRs, we reviewed requirements contained in the Economic Growth and Regulatory Paperwork Reduction Act of 1996 (EGRPRA) for reviewing existing rules, as well as requirements contained in the Consolidated Appropriations Act, 2016 for banking regulators to study the impact of changes to the capital treatment of MSRs. We also interviewed officials from CFPB and banking regulators about their plans for retrospective reviews. Additionally, we reviewed prior GAO work that addresses important characteristics for conducting high-quality reviews of regulations' impacts.

To address all the objectives, we conducted semistructured interviews with federal regulators, including officials from the Board of Governors of the Federal Reserve System (Federal Reserve), CFPB, Federal Deposit Insurance Corporation (FDIC), Office of the Comptroller of the Currency, National Credit Union Administration (NCUA), and officials from industry associations selected for their affiliation with community banks or credit unions, including American Bankers Association (ABA), Independent

Community Bankers of America (ICBA), Credit Union National Association (CUNA), National Association of Federal Credit Unions, and academics and other industry participants such as mortgage brokers and a rating agency selected based on our literature review. We also interviewed representatives from three credit union service organizations and two consumer groups—the Center for Responsible Lending and the National Consumer Law Center.² We also interviewed representatives from Fannie Mae and Freddie Mac; Ginnie Mae; and the Federal Housing Administration and the Department of Veterans Affairs, which insures or guarantees, respectively, loans in Ginnie Mae-guaranteed mortgage-backed securities (MBS).

We interviewed community lenders of a range of sizes and different levels of experience with respect to mortgage servicing and MSR. Our selection factors were based on available data in the Consolidated Reports of Condition and Income (commonly referred to as Call Reports) and the Credit Union 5300 Call Reports. For example, for credit unions we used the number of mortgage loans as an indicator of size because CFPB's mortgage servicing rules include an exemption from some rules for small servicers. The term "small servicer" generally applies to institutions that service 5,000 mortgages or fewer. For community banks, we used asset size as our measure of size for the community banks rather than loan count because bank Call Reports do not track the number of loans.³

For our core sample of community lenders, we interviewed representatives from a total of eight community banks and six credit unions. However, we also interviewed a few additional community lenders for additional perspective for a total of nine community banks and seven credit unions. Although no commonly accepted definition of a community

²Credit union service organizations are entities that are owned by federally chartered or federally insured state-chartered credit unions and that are engaged primarily in providing products or services to credit unions or credit union members. See 12 C.F.R. § 712.1(d).

³We used the Federal Deposit Insurance Corporation's definition of a community bank, which incorporates an asset size threshold—generally including banks with less than \$1 billion in assets—and other characteristics. The asset size threshold is not a strict requirement. Larger banks may be considered community banks if they meet other criteria such as having a loan-to-asset ratio greater than 33 percent. See Federal Deposit Insurance Corporation, *FDIC's Community Banking Study*.

bank exists, the term often is associated with smaller banks that provide relationship banking services to the local community and have management and board members who reside in the local community. While most credit unions are relatively small, we focused our interview selections on larger credit unions as additional servicing requirements apply to institutions with more than 5,000 loans. We also sought to gain perspectives from a credit union that may be approaching the 5,000 loan threshold. In addition to size, we included as a selection factor whether institutions had MSR, including some institutions that had MSR and some that did not (see table 1). Finally, separate from our core sample of interviews, we interviewed one community bank and one credit union as we developed the methodology and discussion questions for our interview sample. We selected these banks based on referrals from trade associations. For additional context, we also interviewed one regional bank with a large concentration of MSR. Based on our small judgmental sample of community lenders, the responses are not generalizable to the population of community lenders.

Table 3: Number of Community Banks and Credit Unions Interviewed, by Size

	Number of community banks	Description of size	Number of credit unions	Description of size
Small	2	Less than \$100 million in assets	1	11 to 500 mortgage loans
Medium	4	\$100 million to \$1 billion in assets	3	501-500 mortgage loans
Large	2	More than \$1 billion in assets	2	More than 5000 mortgage loans
Total	8		6	

Source: GAO analysis of Call Report information. | GAO-16-448

We also completed a literature search and reviewed recent reports and articles related to the mortgage servicing industry, including industry and academic reports. We identified some literature recommended to us by the institutions we interviewed. In particular, to assess the impact of mortgage-related requirements and mortgage servicing rules issued pursuant to the Dodd-Frank Act, we reviewed an industry survey of a nonprobability sample of banks on the regulatory impact of Dodd-Frank

Act regulations on banks in 2015.⁴ Since the survey relied on a nonprobability sample, the results cannot be used to make generalizations to the population of community lenders or commercial banks and thrifts. We reviewed the methodologies used in the study and determined that they were reasonable for analyzing the issues raised but note that the study has limitations and is not necessarily definitive.

We conducted this performance audit from April 2015 to June 2016 in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives. We believe that the evidence obtained provides a reasonable basis for our finding and conclusions based on our audit objectives.

⁴The American Banking Association's 22nd Real Estate Lending Survey had the participation of 182 banks. The data were collected from March 4, 2015, to April 17, 2015, and in most cases reports calendar year or year-end results. In other cases, data reflect current activities and expectations at the time of data collection. Of the survey participants, 68 percent of respondents were commercial banks and 32 percent were savings institutions. About 77 percent of the participating institutions had assets of less than \$1 billion. The survey was sent out as a web survey to over 3,000 banks including both American Bankers Association member and nonmember banks (commercial banks and thrifts) and elicited responses from 182 banks for a response rate of 6 percent overall. Since the survey relies on a non-probability sample, the results cannot be used to make inferences about all commercial banks and thrifts.

Appendix II: Mortgage Servicing Rights Transfer Activity

This appendix provides additional information about mortgage servicing rights (MSR) transfers. We analyzed data on MSR transfers from Freddie Mac and Ginnie Mae to determine the volume of transfers by type and size of institutions.¹ Table 1 shows the volume of MSR transfers by different types of institutions.

Table 4: Percentage of Residential Mortgage Transfers of Servicing Approved by Freddie Mac or Ginnie Mae by Institution Type, 2010 through 2015

Institution type (seller-to-buyer) ^a	Percentage of MSRs transferred based on unpaid principal balance, 2010–2012	Percentage of MSRs transferred based on unpaid principal balance, 2013–2015 ^b
Bank-to-bank	26.8	9.0
Bank-to-nonbank	33.5	47.7
Nonbank-to-bank	13.4	7.1
Nonbank-to-nonbank	25.0	36.4
Total	100	100

Source: GAO analysis of Freddie Mac and Ginnie Mae data. | GAO-16-448

Note: Totals may not sum to 100 percent due to rounding.

^aBank refers to any insured depository institution (e.g., bank, credit union, thrift). Nonbanks could potentially be owned by a bank even if they are not an insured depository themselves.

^bPeriod is from January 2013 to June 2015, which was the most recent data available.

Table 2 shows additional information about the net MSR transfers by banks of different sizes and nonbanks. In the 2010 to 2012 period, nonbanks and multiple categories of small banks were net purchasers of MSRs approved by Freddie Mac and Ginnie Mae, while the largest banks sold more MSRs than they purchased. In the 2013 to 2015 period, banks in each of the four size categories were net sellers of MSRs, while nonbanks were net purchasers.

¹Data provided by Fannie Mae did not allow GAO to perform a comparable analysis to Freddie Mac and Ginnie Mae.

Table 5: Net Transfers of Mortgage Servicing Rights Approved by Freddie Mac or Ginnie Mae by Institution Type and Size (in billions of dollars of unpaid principal balance), 2010 through 2015

Institution type and size ^a	Net transfers 2010–2012	Net transfers 2013–2015 ^b
Banks with less than \$1 billion in assets	1	-2
Banks with \$1 billion and up to \$10 billion in assets	11	-77
Banks with more than \$10 billion and up to \$50 billion in assets	-4	-10
Banks with more than \$50 billion in assets	-35	-146
All nonbanks	34	236

Source: GAO analysis of Freddie Mac and Ginnie Mae data. | GAO-16-448

Note: The negative amounts indicate that the unpaid principal balance on outstanding loans for which mortgage servicing rights (MSR) were transferred exceeded the unpaid principal balance on outstanding loans for which MSRs were purchased. Data provided by Fannie Mae did not allow GAO to perform a comparable analysis to Freddie Mac and Ginnie Mae data. Net transfers for all institution types do not equal zero because institution size could not be determined for some buyers or sellers, and these transactions are not included in the table.

^aBank refers to any insured depository institution (e.g., bank, credit union, thrift). We did not categorize nonbanks by size. Nonbanks could potentially be owned by a bank even if they are not an insured depository themselves.

^bPeriod is from January 2013 to June 2015, which were the most recent data available.

Appendix III: Comments from the Bureau of Consumer Financial Protection



1700 G Street, N.W., Washington, DC 20552

June 8, 2016

Mr. Mathew J. Scirè
Director, Financial Markets and Community Investment
U.S. Government Accountability Office
441 G Street, NW
Washington, DC 20548

Dear Mr. Scirè:

Thank you for the opportunity to comment on the Government Accountability Office's draft report, titled *Mortgage Servicing: Community Lenders Remain Active under New Rules, but CFPB Needs More Complete Plans for Reviewing Rules (GAO-16-448)*. GAO's draft report contains important information about institutions' continued ability to service mortgages while complying with new rules intended to protect consumers and strengthen the financial services industry. I appreciate GAO's willingness to consult with the Consumer Financial Protection Bureau over the course of this engagement.

GAO's draft report contains key findings that address, and should alleviate, institutions' initial concerns regarding compliance with regulatory agencies' new capital and servicing rules, including the Bureau's mortgage servicing rules. As GAO's report recognizes, the Dodd-Frank Act authorized the Bureau to exercise its authority to "prescribe rules . . . as may be necessary or appropriate to enable the Bureau to administer and carry out the purposes and objectives of the Federal consumer financial laws, and to prevent evasions thereof."¹ The Bureau's mortgage servicing rules were designed to "provide better disclosure to consumers of their mortgage loan obligations and to better inform consumers of, and assist consumers with, options that may be available for consumers having difficulty with their mortgage loan obligations." The rules also focus on critical responsibilities for servicers, including obligations to correct errors, credit payments, and provide accurate statements to consumers.²

The draft report concludes that both large banks and smaller community banks and credit unions continue to consider the mortgage servicing market important to their business models and have taken steps to comply with these new rules. GAO makes several significant findings with

¹ 12 U.S.C. § 5512(b)(1), Pub. L. 111-203, Title X, § 1022(b)(1) (July 21, 2010).

² Mortgage Servicing Rules Under the Real Estate Settlement Procedures Act (Regulation X), 78 Fed. Reg. 10696 (Feb. 14, 2013), and Mortgage Servicing Rules Under the Truth in Lending Act (Regulation Z), 78 Fed. Reg. 10902 (Feb. 14, 2013), as amended. Congress required the Bureau to implement several new provisions under the Real Estate Settlement Procedures Act and the Truth in Lending Act, as amended, which are addressed as part of the final rules. See Pub. L. 111-203, Title XIV, §§ 1418, 1420, 1463, and 1464 (July 21, 2010).

respect to smaller institutions' participation in the servicing market, stating that since implementation of the Bureau's rules, the share of mortgages serviced by community banks and credit unions has increased, and has almost doubled between 2008 and 2015. In addition, though some industry surveys suggested that increased compliance costs could create additional burden, the draft report states that several "representatives at community banks and credit unions [that GAO] spoke with commented that CFPB's exemptions [in its rule] for small servicers and creditors had been helpful to their business and customers ... [and] community lenders noted that CFPB's small servicer exemption ... had been helpful in reducing some of their compliance requirements." According to GAO, its "analysis suggests that these lenders generally appear to be participating in residential mortgage lending much as they have in the past."³

GAO's draft report also focuses on retrospective review of the mortgage servicing rules by regulatory agencies and includes a recommendation that the Bureau take steps to complete its plan for conducting a review of the mortgage servicing rules. The Bureau concurs with this recommendation.

The Dodd-Frank Act requires the Bureau to "conduct an assessment of each significant rule or order adopted by the Bureau ... [and] to publish a report of its assessment ... not later than 5 years after the effective date" of the rule.⁴ A report of the Bureau's mortgage servicing assessment is due by January 2019.

GAO acknowledges significant distinctions between the Bureau and other regulatory agencies with respect to the requirements for retrospective review of rules. Under the Dodd-Frank Act, the Bureau's assessments of significant rules are required to "reflect available evidence and any data that the Bureau reasonably may collect" and the Bureau must "invite public comment on recommendations for modifying, expanding, or eliminating" the newly adopted rule.⁵ These requirements are unique to the Bureau. As GAO identifies in its draft report, certain agencies responsible for regulating financial institutions are required to conduct a review of applicable regulations every 10 years under the Economic Growth and Regulatory Paperwork Reduction Act to identify potentially outdated or burdensome rules. However, these agencies' retrospective reviews do not contain the same statutory obligations, including with respect to timing and data collection and analysis, required by the Bureau under the Dodd-Frank Act.

The Bureau has taken significant steps as it plans for the assessment requirements in the Dodd-Frank Act, including completion of the mortgage servicing assessment and public report by January 2019. As GAO reports, the Bureau has completed a preliminary planning document that identifies potential methodologies for measuring outcomes as it commences its mortgage servicing assessment.

The draft report emphasizes the importance of ensuring that plans provide for sufficient time to conduct an effective review and the Bureau agrees that such timing considerations are a

³ GAO, *Mortgage Servicing: Community Lenders Remain Active under New Rules, but CFPB Needs More Complete Plans for Reviewing Rules* (GAO-16-448).

⁴ 12 U.S.C. § 5512(d), Pub. L. 111-203, Title X, § 1022(d) (July 21, 2010).

⁵ 12 U.S.C. § 5512(d)(1)-(3), Pub. L. 111-203, Title X, § 1022(d)(1)-(3) (July 21, 2010).

**Appendix III: Comments from the Bureau of
Consumer Financial Protection**

necessary component of any successful plan. The Bureau continues to sharpen its plan for assessment of the servicing rules. As part of this effort, we intend to refine the scope and relative emphases of the assessment, the outcomes the assessment will likely focus on, the ways we hope to be able to measure these outcomes, the qualitative and quantitative information we may use, and the cost to gather information we do not already possess. The Bureau intends to finalize its plan by incorporating each of these elements, while ensuring that sufficient time is allotted to make modifications should potential improvements or identified costs necessitate revision.

The Bureau will continue to update GAO as we finalize our plans. The Bureau is dedicated to completing its mortgage servicing assessment and releasing a report of its assessment, as required, to better inform the public.

Sincerely,



Richard Cordray
Director

Appendix IV: Comments from the National Credit Union Administration



National Credit Union Administration
Office of the Executive Director

June 3, 2016

SENT BY E-MAIL

Jill Naamane
Assistant Director, Financial Markets and Community Investment Issues
U.S. Government Accountability Office
441 G Street, NW
Washington, DC 20548
naamani@gao.gov

Dear Assistant Director Naamane:

We have reviewed the GAO's draft report entitled *Mortgage Servicing: Community Lenders Remain Acting under New Rules, but CFPB Needs More Complete Plans for Reviewing Rules* (GAO-16-448). We agree with the report's conclusions as they relate to NCUA and the credit union industry. In particular, we agree with your conclusion that NCUA's capital treatment of MSR is unlikely to affect most credit unions.

Thank you for the opportunity to comment.

Sincerely,

A handwritten signature in blue ink that reads "Mark Treichel".

Mark Treichel
Executive Director

1775 Duke Street – Alexandria, VA 22314-3428 – 703-518-6320

Appendix V: GAO Contact and Staff Acknowledgments

GAO Contact

Mathew J. Sciré (202) 512-8678 or sciremj@gao.gov

Staff Acknowledgments

In addition to the contact named above, Jill M. Naamane (Assistant Director), Janet Fong (Analyst-in-Charge), Farah B. Angersola, Bethany M. Benitez, Emily R. Chalmers, Pamela R. Davidson, Janet C. Eackloff, Kendra R. Froshman, Justin P. Gordinas, Cynthia L. Grant, Courtney L. LaFountain, Marc W. Molino, Steve Robblee, Jennifer W. Schwartz and James D. Vitarello made key contributions to this report.

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