NATIONAL ASSOCIATION OF REALTORS®

The Voice For Real Estate®

500 New Jersey Avenue, NW
Washington, DC 20001-2020
www.REALTOR.org
202.383.1184 Fax 202.383.1031
E-mail: dlereah@realtors.org

David A. Lereah, Ph.D.
Senior Vice President,
Chief Economist

March 26, 2007

Office of the Comptroller
of the Currency
Mail Stop 1-5
250 E Street, SW
Washington, DC 20219
Docket No. 06-15
[Transmitted by e-mail:
regs.comments@occ.treas.gov]

Board of Governors of the Federal
Reserve System
Ms. Jennifer J. Johnson, Secretary
20th Street and Constitution Ave., NW
Washington, DC 20551
Docket No. R-1238
[Transmitted by e-mail:
regs.comments@federalreserve.gov]

Office of Thrift Supervision
Regulation Comments
Chief Counsel's Office
1700 G Street, NW, Washington, DC
20552
No. 2006-49
[Transmitted by e-mail:
regs.comments@ots.treas.gov]

Federal Deposit Insurance Corporation
Robert E. Feldman, Executive Secretary
Attn: Comments/Legal ESS
550 17th Street, NW
Washington, DC 20429
RIN 3064-AC96
[Transmitted by e-mail:
comments@fdic.gov]

Re: Risk-Based Capital Guidelines; Capital Adequacy Guidelines; Capital Maintenance: Domestic Capital Modifications [Basel I-A]

Dear Sir or Madam:

On behalf of the more than 1.3 million members of the National Association of REALTORS® ("NAR"), I am pleased to provide comments to the federal banking agencies regarding the Joint Notice of Proposed Rulemaking (NPR) published on December 26, 2006. The NPR was issued by the federal banking agencies as part of the process of developing a revised Basel I capital framework (Basel I-A) as one alternative for depository institutions that will not be mandated to use the new Basel II advanced standards.

The National Association of REALTORS®, "The Voice for Real Estate," is America's largest trade association, including NAR's five commercial real estate institutes and its societies and councils. REALTORS® are involved in all aspects of the residential and commercial real

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and subscribe to its strict Code of Ethics.

estate industries and belong to one or more of some 1,400 local associations or boards, and 54 state and territory associations of REALTORS®. Thus, to the extent that the proposed Basel I-A framework will have an impact on the availability of credit for residential or commercial real estate financing transactions, the proposal is of vital concern to NAR and its members.

The current risk-based capital regulations date from the late 1980s, when modern techniques for measuring risk and calibrating capital were in their infancy. As a result, the Basel I risk-based capital framework did not relate capital to statistically determined risk baskets, but instead used broad measures of risk based on supervisory estimates. Under the risk-based capital framework, different assets are assigned different “risk weights.” The higher the risk weight, the more capital is required to support the asset. Under Basel I, all commercial loans are placed in the 100 percent risk-weight basket, regardless of the credit-worthiness of the borrower, and 1- to 4-family first residential mortgage loans are generally assigned to the 50 percent basket, despite the extremely low loss rate on these exposures. It is now widely acknowledged by the federal banking agencies, the financial services industry, and academic experts that Basel I does not accurately align capital and risk for our most sophisticated institutions that engage in complex financial transactions, and that the existing standard could be improved upon.

For the large banks, the agencies published a proposal for a new and advanced capital framework that would implement an international capital agreement. This capital standard is referred to as Basel II and would rely on each bank’s internal calculations of such factors as probability of default and loss given a default. NAR is submitting a separate comment letter on the Basel II proposal.

This Basel I-A proposal is designed as an option for those banks that will not be mandated to follow the Basel II standards. Critical goals of this initiative include providing a more risk sensitive capital system for mid-size and smaller banks without imposing the costs and other regulatory burdens that are inherent in the Basel II approach, while at the same time mitigating some of the distortions that are created when financial institutions competing in the same markets are subject to different capital standards. These are laudable and important goals, and we applaud the banking agencies for recognizing the need to deal with these concerns. However, as discussed below, we believe that there are a number of improvements that could be made to make the proposed regulations more effective in achieving these goals and advancing other important public policy interests.

I. Prudently Underwritten Low LTV Residential First Mortgage Loans

The proposal would modify the current 50 percent risk-weight for prudently underwritten first mortgage loans and instead assign a risk-weight based on the loan-to-value (LTV) ratio of the exposure. If a bank or thrift holds both a first and second lien, the institution would combine the loans for purposes of determining the LTV. Risk weights are assigned as follows:

LTV	Risk-weight
60%	20%
Greater than 60% but less than or equal to 80%	35%
Greater than 80% but less than or equal to 85%	50%
Greater than 85% but less than or equal to 90%	75%
Greater than 90% but less than or equal to 95%	100%
Greater than 95%	150%

NAR believes that the proposed risk-weights for prudently underwritten low LTV residential mortgage loans do not reflect the economic risk of these loans, and unless modified, would be inconsistent with the goals of the proposal.

There is no question that prudently underwritten first lien residential mortgage loans have historically low loss rates. According to Federal Reserve Board data, the average charge-off rate for these loans from 1991 through the last quarter of 2006 was 0.15 percent. (A charge-off is the amount of a loan that a bank no longer expects will be repaid.) In 2006, the charge-off rates for residential real estate loans remained consistent with this average:[1]

2006	Charge-off Rate All Banks, S.A.
First Quarter	0.10 percent
Second Quarter	0.09 percent
Third Quarter	0.11 percent
Fourth Quarter	0.12 percent

Residential mortgage delinquency rates have likewise remained low and stable for residential mortgages, and have remained under 2 percent since the third quarter of 2002:[2]

Year	Delinquency Rate All Banks, S.A.
2000	2.10
2001	2.29
2002	2.12
2003	1.83
2004	1.56
2005	1.55
2006: First Quarter	1.60

[1] Federal Reserve Board Statistical Release, Charge-off and Delinquency Rates, All Banks, Seasonally Adjusted (S.A.)

[2] Id.

Year	Delinquency Rate All Banks, S.A.
2006: Second Quarter	1.62
2006: Third Quarter	1.77
2006: Fourth Quarter	1.91

These rates reflect the result of all residential real estate lending. However, the charge-off and delinquency rates for prudently underwritten low LTV loans would be considerably lower, and there is no reason to expect that the loss rates for these safe and traditional mortgage loans will significantly change in the future.

According to an FDIC staff memorandum, under the Basel II advanced approach, the average risk-weight for a "typical" mortgage loan, would be 16 percent.[3] Further, under Basel II, over 60 percent of these loans (presumably the lower LTV loans) would have a risk-weight of *less than 10 percent*.[4] Academic studies indicate that these risk-weights are consistent with the actual economic risk posed by prime mortgage loans.[5] The Basel I-A proposal, on the other hand, applies a 35 percent risk-weight for loans with an LTV as low as 61 percent, and assigns a 20 percent risk-weight only if the LTV is 60 percent or below. These risk-weights are simply too high for the risks presented by these prime loans.

The treatment of *prime* low LTV residential mortgages in the NPR should be modified to reflect the actual risks of these assets. Unless these changes are made, Basel II adopters will have significant capital advantages over other lenders making similar prime mortgage loans. These capital advantages will translate into competitive advantages that will lead to further consolidation in the mortgage lending industry that will ultimately harm consumers.[6] Secondly, unnecessarily high capital requirements are a cost of doing business that will be passed on to consumers in the form of higher interest rates or other fees and charges. Capital requirements that are excessive in light of economic risk represent a regulatory "tax" on the American public that is not in the public interest.

We therefore recommend a risk-weight basket of 10 percent for prime first lien residential mortgage loans with a 70 percent or lower LTV, and a risk-weight basket of 20 percent for prime mortgage loans with a LTV above 70 percent and up to 80 percent. These risk

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[3] FDIC Memorandum of Sandra Thompson, Director, Division of Supervision and Consumer Protection to the Board of Directors, November 7, 2006.

[4] Id.

[5] M. Flannery, Mortgage Bankers Association White Paper: "Likely Effects of Basel II Capital Standards on Competition with the 1 - 4 Family Residential Mortgage Industry," Table 4 (2006) (hereinafter "Flannery").

[6] See, e.g. Calem and Follain, "Proposed Competitive Impacts of Basel II in the U.S. Market for Residential Mortgages," at page 35, Statement Before the House Subcommittee on Financial Institutions and Consumer Credit (May 11, 2005).

baskets would be more in line with the actual risk presented by these assets,[7] and avoid the competitive issues created by different capital frameworks.

II. Calculation of Loan-to-Value Ratio

The NPR provides that the LTV ratio is to be determined at the origination of a first loan at the lower of the purchase price of the property or the appraised value. If there is no appraisal, the lender is to evaluate the value of the property in conformance with the appraisal regulations and lending guidelines. The LTV ratio takes into account private mortgage insurance that is written on the loan level, but not on a pool level. The LTV ratio may only be updated when a refinancing occurs that includes the extension of additional funds, or to reflect the change in the amount of principal as the loan amortizes. If a loan has a negative amortization feature, the increase in the amount of principal must be taken into account quarterly, and the risk weight of the loan adjusted accordingly. If the property values in an area suffer a general decline, the agencies may require additional capital under their supervisory authority.

NAR supports the consideration of private mortgage insurance in determining LTV ratios, but believes that credit should also be given to pool level coverage, and that the agencies should recognize the protection that all forms of mortgage insurance provide. NAR also believes that the LTV ratio should be adjusted in connection with any financing, and not limited to "cash out" refinancing.

III. Treatment of Home Equity Lines of Credit and Second Loans

The NPR proposes to continue the current approach of combining first and second liens and Home Equity Lines of Credit (HELOC) for purposes of determining LTV ratios.[8] Stand alone second loans and stand alone HELOC would be added to the first lien (and any other more senior positions) for purposes of determining the LTV ratio of the junior exposure.[9] The risk-weight for the stand alone exposure would be determined as follows:

LTV of Stand Alone Junior Lien or HELOC	Risk-weight
60 percent or less	75 percent
Greater than 60 but less than or equal to 90	100 percent
Greater than 90	150 percent

As noted previously, if the same lender holds both a first and second loan or HELOC, the two exposures are added together, but the risk weight is based on the same chart as is used for

[7] Flannery at Table 4.

[8] As a general matter, the unfunded portion of HELOC are multiplied by 50 percent, and added to the funded portion to determine the amount of the HELOC that is added to the first lien for LTV purposes.

[9] Risk-weight would be based on both the funded and unfunded portion of the HELOC. The unfunded portion would be multiplied by 50 percent and then added to the funded portion for determining the LTV of the line.

first lien mortgages. For example, a lender holding a first and second loan with a combined LTV of 80 percent would risk weight the entire loan at 35 percent. However, under the NPR, if the second loan is held by a different institution, the combined LTV of 80 percent would result in a risk weight of 100 percent for the second loan. The agencies provide no rationale for why these loans are treated so differently, in light of the fact that both loans are protected by the same proportion of collateral.

IV. Additional Option for Mortgage Rules

The NPR states that non-Basel II banking organizations will be given a choice of either adopting all of the Basel I-A framework or remaining under the Basel I regulation, but not the option of using only parts of the Basel I-A standard. This "all or nothing" approach to Basel I-A is driven by the agencies' concerns regarding competitive equality, and the concern that non-Basel II banks could choose to apply only those provisions of Basel I-A that will reduce capital requirements.

We agree that banking organizations should not be permitted to "cherry pick" those provisions of Basel I-A which will reduce capital, and remain on Basel I for those assets in which that framework provides a capital advantage. Nevertheless, we believe that another alternative should be offered, especially for smaller community banks, that will make the Basel I-A standard a more realistic option while avoiding the "cherry picking" problem.

For many smaller community banks, the additional regulatory burden associated with the Basel I-A standard will outweigh the benefits of the proposal. For some banks, it simply may not be possible to comply with the data required to utilize the new standard, for example, data to correlate loan exposures and credit ratings of borrowers. For other institutions, the cost of compliance will be the issue.

One alternative that could be offered is to permit community based institutions the option of complying with the residential mortgage provisions of Basel I-A only. No additional data should be necessary to comply with the residential mortgage standard, since LTV ratios are already required for loan underwriting. Implementation costs should also be minimal. Further, to the extent that mortgage loans make up a significant percent of the portfolio of many smaller institutions, the results make the institution's capital far more risk-based than under Basel I.

The agencies' concerns over "cherry picking" are also mitigated. The proposal could be restricted to smaller institutions that have limited ability to apply the entire Basel I-A framework, but would be able to apply the new standard to home mortgages. Further, the mortgage opt-in alternative could be made subject to supervisory approval, so that the agencies could be assured that institutions were not inappropriately attempting to "arbitrage" the two available capital frameworks.

V. GSE Securities

The Basel I standard assigns a 20 percent risk-weight to exposures issued or guaranteed by a Government Sponsored Enterprise ("GSE"), such as Fannie Mae or Freddie Mac. The NPR explains that the agencies are considering the use of a new type of rating (Independent Financial Strength or "IFS") to determine risk-weights for GSE exposures. The IFS rating would attempt to measure the risk that the government might have to provide financial support to a GSE, rather than the risk to an investor who holds GSE issued or guaranteed securities.

We believe that basing risk-based capital charges on an IFS rating is inappropriate for a number of reasons, especially with respect to the housing GSEs such as Fannie Mae, Freddie Mac, and the Federal Home Loan Banks.

Capital is held by a bank or thrift to protect *that institution* against a risk of loss. The IFS rating does not relate to a risk to the institution, but rather a risk to the government. A risk to the government is simply not a relevant factor when determining an institution's minimum capital requirement. It should not be a factor in determining the risk-weight to be assigned to GSE securities held by depository institutions.

The proposal would also have a negative impact on the housing finance markets and would increase costs to consumers. Under the proposal, depository institutions and the financial markets would not be able to rely on a consistent 20 percent risk-weight for GSE issued or guaranteed securities. Rather, the risk-weight could change at any time through an IFS downgrade. Therefore, an existing portfolio of mortgage-backed securities could suddenly require a higher capital allotment simply because a rating agency down grades the GSE's IFS rating, even if the investor credit rating remains unchanged. As a result, the market will demand an additional premium to hold these securities to account for the additional uncertainty in capital requirements. These additional costs will result in higher funding costs for the GSE, which will in turn raise the costs to consumers.

Finally, the proposed use of IFS ratings is contrary to the long-standing public policy instituted by Congress to assist the housing finance market by encouraging investments in GSE securities. The Congress has repeatedly enacted laws to encourage investment in GSE securities and to favor these investments. These Congressional policies will be undermined by a regulatory approach that makes investments in housing GSEs more expensive.

VI. Multifamily Residential Mortgages and Residential Acquisition, Development, and Construction Loans

The NPR is not proposing to change the risk-weight for loans secured by multifamily properties or for loans for the acquisition, development, and construction of 1- to 4-family residential properties or loans. With certain exceptions discussed below, these loans are placed in the 100 percent risk-weight category.

NAR believes that multifamily residences with a history of high occupancy and revenue generation are much less risky than other, more speculative multifamily loans, and that the risk-weight for these loans should be lowered in order to more accurately reflect the risk of these assets.

This is consistent with the Basel II Accord. Under Basel II, loans secured by multifamily residential real estate in which the funds for repayment are generated by rental income are treated as "income producing real estate" (IPRE). For certain banks, this group of assets is afforded a lower risk-weight than loans secured by other types of commercial real estate.[10] Likewise, we believe that a loan secured by a multifamily residential project with a high occupancy rate and history of revenue generation should also be treated more favorably.

Finally, we note that certain ADC (acquisition, development, and construction) loans secured by pre-sold 1- to 4-family residences are placed in the 50 percent risk-weight pursuant to federal statute.[11] To qualify under the statute, the loan must finance the construction of the residence, the residence must be subject to a binding sales agreement with a purchaser who has qualified for his or her mortgage in an amount sufficient to complete the purchase, and the purchaser must have placed a non-refundable deposit with the builder. Certain loans secured by multifamily properties are also assigned to the 50 percent risk-weight pursuant to this statute.

These provisions were added to the Resolution Trust Corporation Refinancing, Restructuring and Improvement Act of 1991 by the Barnard-Wylie Amendment. The legislative history indicates that Congress was motivated by a desire to lower the capital charge for these loans, and that the 50 percent figure was selected because of the desire to retain consistency with the international Basel I Accord.[12]

The statutory provision should not be viewed as a strict floor for the regulatory treatment of these loans under the new Basel I-A framework. Rather, the statute should be interpreted as applying to the Basel I framework only, and should not limit the ability of the agencies to set a lower risk-weight for loans on pre-sold residential property that more accurately reflects the risk

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[10] Under the Basel II advanced approach, commercial real estate is divided into two categories: income-producing real estate (IPRE) and high-volatility commercial real estate (HVCRE). IPRE is characterized by the fact that the repayment of the loan is based on cash flows generated by the real estate, such as rent payments. HVCRE is characterized by loans secured by real estate in which repayment is based on the future sale of the property, such as loans for the acquisition, development and construction of a new housing development. For those depository institutions that do not compute their own "probability of default" for commercial real estate loans, the Basel II Accord will assign a risk weight for IPRE and HVCRE assets. The Accord assigns IPRE loans a lower risk-weight than HVCRE loans with similar probabilities of default. For example, a "strong" IPRE loan (with a low probability of default) is assigned a risk-weight of 70 percent, but a HVCRE loan with a similar probability of default is assigned a risk-weight of 90 percent.

[11] Section 618 of the Resolution Trust Corporation Refinancing, Restructuring and Improvement Act of 1991, Public Law 102-233 (1991) (RTCRRIA).

[12] See, for example, the Statements of Congressman Wylie and Congresswoman Morella, the authors of the provision, at 137 Cong. Rec. H11842 (1991).

of these exposures. This would be consistent with Congressional intent to reduce the capital charge for these loans and not to legislatively override the Basel I Accord.

VII. Conclusion

NAR supports the goals of the federal banking agencies to improve the current capital standards in order to make them more risk sensitive and to ameliorate potential competitive disparities. The proposal contains many positive changes along these lines. However, there are also several areas in which the proposal could be improved to better achieve these goals and to ease the compliance burden.

We hope that you find these comments helpful. If you have any questions, please feel free to contact Jeff Lischer, Manager, Financial Services (202.383.1117; jlischer@realtors.org).

Sincerely yours,

David A. Lereah
Senior Vice President, Chief Economist