CBA | CONSUMER BANKERS ASSOCIATION

Mr. Robert deV. Frierson
Board of Governors of the Federal Reserve System
20th Street and Constitution Avenue, N.W.
Washington, D.C. 20551
Docket NoR-1442 and
RIN No. 7100 AD 87

Mr. Robert E. Feldman
Executive Secretary
Attention: Comments/Legal ESS
Federal Deposit Insurance Corporation
550 Seventeenth Street, N.W.
Washington, D.C. 20429
RIN 3064-AD 96 and
RIN 3064-AD 95

Office of the Comptroller of the Currency
250 E. Street S.W., Mail Stop 1-5
Washington, D.C. 20219
Docket ID OCC-2012-0009 and
Docket ID OCC-2012-0008

RE:

Regulatory Capital Rules: Standardized Approach for Risk-Weighted Assets; Market Discipline and Disclosure Requirements; and

Regulatory Capital Rules: Regulatory Capital, Implementation of Basel III, Minimum Regulatory Capital Ratios, Capital Adequacy, Transition Provisions, and Prompt Corrective Action

Dear Sir or and Madam:

I am submitting this comment letter on behalf of the Consumer Bankers Association (CBA).[1] The CBA appreciates the opportunity to comment on your proposed regulations to

[1] The Consumer Bankers Association (CBA) is the only national financial trade group focused exclusively on retail banking and personal financial services — banking services geared toward consumers and small businesses. As the

revise the capital requirements of banks and bank holding companies. As you know, capital provides an important buffer for banking organizations, allowing them to absorb losses without becoming insolvent. During the financial crisis it became clear that many financial companies had insufficient levels of capital to offset the losses that grew from the bursting of the housing bubble. We, therefore, commend the regulatory agencies for revisiting the existing capital rules, and developing a new and stronger framework. We agree on many of the proposed changes, including requiring financial institutions to rely more heavily on common equity as a measure of capital sufficiency. However, we are concerned that many of the proposed changes may be counterproductive to the goals of the Basel Accord and to the economic recovery of the housing industry.

The changes in the capital rules relating to mortgages will harm the economy and the interests of consumers by unnecessarily raising the cost of home finance. This will undermine the recent actions of the Federal Reserve Board ("QE III") to reduce mortgage interest rates and spur economic recovery. The effects will be spread throughout the economy since the housing recovery is key to increasing employment in almost every sector, and especially for the small businesses that provide services both to the construction industry and to home owners.

This letter will set forth our concerns in more detail. Our comments will concern mostly the "standardized approach" proposal and will focus for the most part on the impact on the mortgage markets, which is one of the areas of focus at the CBA. Where our comments relate to the accompanying "minimum regulatory capital ratios" proposal, we will so indicate in the body of the letter.

I. INTRODUCTION

Our concerns with the proposed capital rules can be broken down into four major areas.

First, the standardized approach NPR is not consistent with two of the overriding goals of risk-based capital regulation: (i) capital requirements that reflect the underlying economic risk of the bank's assets and activities; and (ii) international consistency in capital requirements. As we will discuss below, the proposed rule does not correctly evaluate the risk of mortgage lending after the financial crisis when both market forces and regulatory developments have made mortgage underwriting standards extremely rigorous. This proposal would impose unnecessarily high capital charges on both first and second mortgage loans, which will increase the cost of these products and hurt both consumers and our economic recovery. Additionally, the proposed regulation also will put U.S. banking organizations at a competitive disadvantage to non-bank lenders and foreign banks.

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recognized voice on retail banking issues, CBA provides leadership, education, research, and federal representation on retail banking issues. CBA members include most of the nation's largest bank holding companies as well as regional and super-community banks that collectively hold two-thirds of the industry's total assets.

Second, both proposals will impede the securitization of mortgage loans, will hamper the reinvigoration of a secondary market for non-conforming loans, and will encourage the growth of Fannie Mae and Freddie Mac (the "GSEs") at the expense of private capital. The result will be increased costs for mortgages, especially non-conforming loans, and even more dependence on the two GSEs for financing housing loans. This will be harmful to our economic recovery and run counter to the expressed public policy goals for the GSEs and housing finance.[2]

Third, the standardized approach NPR is not consistent with rulemaking norms in that it is not based on factual data, fails to distinguish between loans made by regulated banks and loans originated by unregulated entities, and fails to take into account the additional regulatory constraints on mortgage lending that will apply going forward. The agencies need to conduct further studies, along the line of the qualitative impact study (QIS) conducted in connection with the Advanced Approach, as well as a more thorough analysis of the likely risks presented by mortgage lending in light of the market and regulatory developments since 2008. We believe that the agencies should, therefore, reconsider this proposal after conducting the necessary studies and qualitative impact surveys that are needed to obtain the data necessary to align risk and capital requirements and to more fully appreciate the impact of regulatory changes on our economic recovery.

Fourth, it is critical that any significant changes in the capital rules should not be applied retroactively to assets already on the books of our banking organizations as of the effective date of any new capital requirement. Retroactive application would be both unfair to regulated banking organizations, and would greatly magnify the significant adverse consequences of the new capital requirements.

Before proceeding to our discussion of these four concerns, we want to point out that in the U.S., the Basel III Accord does not mandate new risk weights for mortgage loans for U.S. banking organizations. Therefore the agencies have the discretion to revise the proposal without regard to the Basel III agreement. We note that the preamble specifically acknowledges this fact with respect to the proposed risk-weights on mortgages,[3] but the rationale applies to all of the changes that would be applied to banks not subject to the advanced approaches.

[2] See, e.g., Statement of the Secretary of the Treasury as Chairman of the Financial Services Oversight Committee before the Senate Committee on Banking, Housing and Urban Affairs, July 26, 2012. ("The U.S. housing finance system has required extraordinary government support since the financial crisis, and the market continues to lack sufficient private capital….(T)he return of private capital is crucial to reestablishing confidence in the integrity of the market and better aligning incentives.")

[3] "The agencies are proposing a risk-weight framework [for mortgages] that is different from both the general risk-based capital rules and the Basel capital framework." 77 Fed. Reg. 52888, 52898 (2012).

In short, we believe the proposed risk weights are excessive, not supported by data, will have a profound impact on consumers, and will create an unlevel playing field for U.S. banks. We therefore propose that the agencies reconsider the proposed risk weights after conducting the necessary studies, as further described below.

II. THE PROPOSAL IS NOT CONSISTENT WITH TWO OF THE OVERRIDING GOALS OF RISK-BASED CAPITAL REGULATION: (I) CAPITAL REQUIREMENTS THAT REFLECT THE UNDERLYING ECONOMIC RISK OF THE BANK'S ASSETS AND ACTIVITIES; AND (II) INTERNATIONAL CONSISTENCY IN CAPITAL REQUIREMENTS

A. Capital Charges Should Reflect Economic Risk

A fundamental goal of any risk-based capital system is to correlate capital charges and the underlying risks of the bank's assets and off-balance sheet activities.[4] If a capital charge is not adjusted for risk, financial institutions have an economic incentive to invest in higher returning, but riskier assets.[5] For example, if the capital cost to a bank is the same for investing in a high yield bond as it is for investing in a Treasury security, institutions will be incented to make the riskier investment in order to boost the company's return on equity. However, if capital requirements are adjusted to reflect risk, the *capital based* motivation for taking on risk will be reduced or eliminated. The importance of linking capital and risk cannot be overstated. In fact, this was the primary reason why the international banking regulators adopted the Basel II framework that provides for more sophisticated and discrete capital adjustments in order to reflect more closely actual risk.[6] The Basel III modifications are, in many respects, an attempt to refine further the risk sensitivity of the capital rules.[7]

B. Proposed Risk-Weights For Mortgages Should Be Reduced

The proposed regulation would lead to significant increases in the capital charges for mortgage loans by raising the risk-weight assigned to mortgages with a loan-to-value ratio (LTV) in excess of 80 percent. The capital charges would increase even more for loans with an LTV above 90 percent. Unlike the current rules, the existence of private mortgage insurance would not be taken into account when calculating the loan's LTV. The inability to allow private mortgage insurance to reduce a loan's LTV for capital purposes will have a particularly adverse impact on our members' efforts to make loans in low- and moderate-income areas, where higher

[4] D. Tarullo, "Banking on Basel" 45-46, 83 (2008)(hereinafter "Tarullo").
[5] Id. at 16-18.
[6] See 71 Fed. Reg. at 55832 (2006) (The Basel II framework "is intended to produce risk-based capital requirements that are more risk-sensitive than the existing risk-based capital rules.)"
[7] Basel Committee on Banking Supervision, Basel III: A Global Regulatory Framework for More Resilient Banks and Banking Systems (Rev. June 2011). In addition, the Basel III modifications deal with systemic concerns as well as with the risk presented by individual institutions.

LTV loans are often required. In fact, both Fannie Mae and Freddie Mac (the "GSEs") require mortgage insurance for loans made in these areas. And because higher capital charges will result in either less lending or higher interest rates, it could result in a disparate impact on minorities that have traditionally relied on higher LTV loans. Under some current proposals, this could result in lending institutions becoming subject to fair lending litigation.[8]

The proposal divides mortgages into two categories. Category 1 loans must be a first lien (with one exception noted below), with terms of 30 years or less, and they cannot have a balloon payment, an interest only period or negative amortization feature. The borrower's income must be fully verified. For adjustable rate mortgages, any increase in the interest rate cannot exceed 2 percent per year, or 6 percent over the life of the loan. These requirements are very similar to the recently proposed definition of a "Qualified Mortgage," under section 1412 of the Dodd-Frank Act.[9] Under the NPR, all other mortgages are Category 2 loans and are subject to appreciably higher risk-weights.

The exception regarding second loan exposures applies if the same institution holds the first lien and a junior exposure (either a second loan or a HELOC), and there are no intervening positions. In this case the lender is to combine both exposures (using the full amount of the HELOC that could be drawn) to determine the LTV for the combined loans. If *both* the first lien and the junior exposure meet the requirements for Category 1, the combined loans will be considered Category 1. However, if *either* exposure does not meet the criteria for a Category 1 loan, then the combined exposure will become Category 2. Thus, even if a first lien would be considered Category 1, if the lender extends a HELOC without an interest rate cap or with an interest only feature, which are both very common features, then *both* the first mortgage and the HELOC would be considered Category 2 loans.

Once the loan Category and LTV is determined, the risk-weight is to be determined pursuant to the following charts:

Category 1 Loans

LTV	**Risk-weight**
60 % or less	35%
80 % or less	50%
90 % or less	75%
Above 90%	100%

[8] See comments from Dave Stevens at: thttp://speakingofrealestate.blogs.realtor.org/2012/07/30/qm-qrm-basel-iii-mortgages-for-the-wealthy/

[9] The major differences are that in the proposed definition of a QM mortgage, points and fees are limited to 3 percent, and the mortgage underwriting will have to comply with any debt to income or residual income guidance that may later be issued by the prudential regulators. The QM proposal would also prohibit prepayment penalties 3 years after loan origination. 76 Fed. Reg. 27390 (May 11, 2011).

Category 2 Loans

LTV	Risk-Weight
80% or less	100%
90% or less	150%
Over 90%	200%

The standardized approach proposal provides no quantitative data or other evidence to support the proposed risk-weights that are significantly higher than current requirements and do not correlate with the underlying risks. Instead, the preamble recites the increase in mortgage defaults and home foreclosures caused by the decline in underwriting standards during the housing bubble. The discussion emphasizes as a root cause the use of non-traditional loan products and practices:[10]

> During the recent market turmoil, the U.S. housing market experienced significant deterioration and unprecedented levels of mortgage loan defaults and home foreclosures. The causes for the significant increase in loan defaults and home foreclosures included inadequate underwriting standards; the proliferation of high-risk mortgage products, such as so-called pay option adjustable rate mortgages, which provide for negative amortization and significant payment shock to the borrower; the practice of issuing mortgage loans to borrowers with unverified or undocumented income; and a precipitous decline in housing prices coupled with a rise in unemployment. Given the characteristics of the U.S. residential mortgage market and this recent experience, the agencies believe that a wider range of risk weights based on key risk factors is more appropriate for the U.S. residential mortgage market. Therefore, the agencies are proposing a risk-weight framework that is different from both the general risk-based capital rules and the Basel capital framework.

This rationale is simply *not applicable* to mortgage loans made by federally regulated banking organizations going forward. It does not take into account the statutory, regulatory and market changes that have occurred since 2008, and it results in proposed capital charges that are not consistent with the risk presented by mortgage loans that have been made since the collapse of the housing bubble and that will be made going forward. The proposed regulation also fails to take into account that loans originated by many federally regulated banking institutions did not exhibit the risk characteristics of the non-traditional subprime loans originated by other lenders.

[10] 77 Fed. Reg. 52888, 52898 (2012).

Further, the proposal ignores the fact that Category 1 mortgages would, by definition, not include the risky loan structures (such as option-ARM features) and underwriting practices (such as no-doc loans) that were cited in the preamble as being most problematic. Imposing significant capital increases on mortgages that essentially meet a QM type underwriting standard is inappropriate. The proposed regulation also fails to consider that banking organizations based lending decisions on a multitude of factors in addition to the LTV. For example, a high LTV loan made for a borrower with a high FICO and large portfolio of investments may be significantly safer than a loan with a lower LTV loan made to a borrower with a borderline FICO score.

The NPR solicited input on whether private mortgage insurance should be recognized for purposes of adjusting the applicable LTV. Private mortgage insurance provides an important safeguard for higher LTV loans, but only if the mortgage insurance company is financially strong. We believe that the regulatory agencies and state insurance commissions should be able to develop minimum financial requirements for mortgage insurance providers, based on the expected performance of *traditionally underwritten loans* during economic recessions, such that it would be appropriate to continue the practice of considering the existence of mortgage insurance for LTV purposes.

C. Proposal Needs to Take Into Account Regulatory Environment and Market Developments

As noted in the preamble, a major cause for the increase in loan defaults and home foreclosures was the proliferation of non-traditional high risk mortgage products and practices. These include the pay-option adjustable rate mortgage, mortgages that were issued without appropriate verification of income and assets, and artificially low teaser rate loans coupled for an initial two or three year period, as well as provisions allowing for negative amortization, interest-only payments, and the use of "piggy-back" second loans to effectively eliminate any down payment requirement. Numerous studies support this view, [11] and point out that the worst performing loans often included two or more high risk features.[12]

Since the collapse of the housing bubble, mortgage lenders have seen an overlay of new statutory and regulatory requirements (as well as a multitude of proposals that are expected to be adopted in the near future) that effectively prevent the use of non-traditional products and

[11] See, e.g., Board of Governors of the Federal Reserve System, Report to the Congress on Risk Retention 2 (Oct. 2010)("(Mortgage) losses appear to be driven primarily by the large drop in nominal house prices and its effect on loans made to borrowers with weak credit histories, unverified income, or with nontraditional amortization structures.); C. Mayer, K. Pence, S. Shurland, Federal Reserve Board Finance and Economic Discussion Series, "The Rise in Mortgage Defaults" 3-4 (2008).
[12] K. Geradi, A. Lehnert, S. Shurland, P. Willen, "Making Sense of the Subprime Crisis," Federal Reserve Bank of Boston, Public Policy Discussion Paper 09-1 (2009).

practices, as well as impose other restrictions and controls. These new laws and regulations include the Secure and Fair Enforcement for Mortgage Licensing Act of 2008 (SAFE Act)[13] that establishes a nationwide requirement for the licensing and testing of mortgage originators and the Dodd-Frank Act that prohibits a creditor from making a mortgage loan without considering the ability of the borrower to repay.[14] The Dodd-Frank Act also imposes a risk retention requirement on mortgage securitization structures to ensure that only high quality loans will be sold into these structures.[15] The Consumer Financial Protection Bureau (CFPB) has the authority to prevent any mortgage practice or product it determines to be unfair, deceptive or abusive.[16] The CFPB has already issued proposed rules regarding mortgage disclosure requirements, mortgage servicing practices,[17] and high cost mortgage points and fee thresholds.[18] The CFPB is working with the other banking agencies to develop rules on real estate appraisals, credit, and mortgage broker licensing and training, as well as permissible fee structures for mortgage brokers.[19]

As referenced above, the CFPB is also responsible for implementing the Dodd-Frank Act requirement that a creditor not originate a mortgage loan without first making a reasonable determination that the borrower has the capacity to repay the loan. The Bureau is expected to issue by early next year a regulation defining the requirements for a "qualified mortgage" (QM) that will be presumed to satisfy the Dodd-Frank Act's "reasonable ability to repay" requirement.[20] As mentioned earlier, the criteria for a QM mortgage laid out in the Dodd-Frank Act are very similar to the proposed standards for a Category 1 mortgage under this proposal.[21]

The regulated sector of the mortgage industry is now, and in the future will be, much more heavily regulated than it was in the past. Mortgage lenders and mortgage brokers will be subject to a new regulatory environment that will effectively require high quality underwriting necessary to conform to the QM and QRM standard (for those securitizing loans), as well as the new oversight that will be provided by the CFPB.[22] In addition to the regulatory overlay, the financial markets now demand very stringent loan underwriting. Our economy is experiencing the effects of these changes. There is widespread concern in the housing markets because banks and other lenders are demanding far higher credit quality than they did even before the bubble.[23]

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[13] Title V of the Housing and Economic Recovery Act of 2008, Public Law 110-289 (2008).
[14] Section 1411 of the Dodd-Frank Act.
[15] Section 941 of the Dodd-Frank Act.
[16] Title X of the Dodd-Frank Act.
[17] 77 Fed. Reg. 57200 and 57318 (Sept. 17, 2012).
[18] 77 Fed. Reg. 51116 (Aug. 23, 2012); 77 Fed. Reg. 49040 (Aug. 15, 2012).
[19] The CFPB proposals relating to mortgage lending and the QM standard are summarized at: http://files.consumerfinance.gov/f/201205_cfpb_MLO_SBREFA_Outline_of_Proposals.pdf
[20] Id.
[21] See note 8, supra.
[22] We recognize that mortgage lenders can opt not to comply with the QM requirement. However, failure to do so will not excuse the lender from complying with the ability to repay standard, which will in itself motivate much tighter loan underwriting.
[23] Joint Center for Housing Studies Harvard University, *The State of the Nation's Housing* 2012 at 19.

All of these statutory, regulatory and market constraints on mortgage lending are in addition to the fact that Category 1 loans, by definition, must comply with an "ability to repay" standard, require verification of financial data, and may not have features such as negative amortization. The existence of these requirements, even in the absence of all of the other regulatory mandates and safeguards, should negate the need for any change in the risk weight of mortgages. In our view, the standardized approach NPR does not appear to be based on sufficient data that takes into consideration all the relevant factors relating to the cause of the mortgage meltdown and the quality of mortgage underwriting that will be mandated going forward.

Due to these factors, it is clear that the proposed increases in risk-weights for mortgages do not reflect the credit risks new mortgage loans present to financial institutions. The problem for our economy at this time is not unsafe mortgage lending but the reluctance of private capital to enter the market. The need for higher capital for mortgage loans in light of these facts is highly questionable and likely to impede responsible mortgage lending.

D. Proposed Risk-weights for Second Liens *and* Home Equity Lines of Credit Need to be Adjusted

The CBA is very troubled by the proposed treatment of home equity lines of credit and other junior lien mortgage loans. Many of our members provide junior liens to their mortgage customers and, therefore, these banking organizations hold both the first lien and a second lien position. Most HELOCs made by our members would be considered Category 2 exposures either because the variable rate associated with these products is indexed, but not capped, or because they may have a balloon payment feature or allow for an interest only repayment during an initial draw period.

The CBA strongly agrees that "piggyback" lending, in which a loan originator makes a second loan to fund the down payment on the first loan, is an unsafe practice that contributed to the financial crisis.[24] However, traditionally underwritten HELOCs and closed-end second loans that are not used to permit high risk borrowers to fund the entire down payment on first mortgages have historically not exhibited unusually high default or foreclosure rates. Even during the financial crisis, HELOCs performed similarly to *prime* first mortgages.

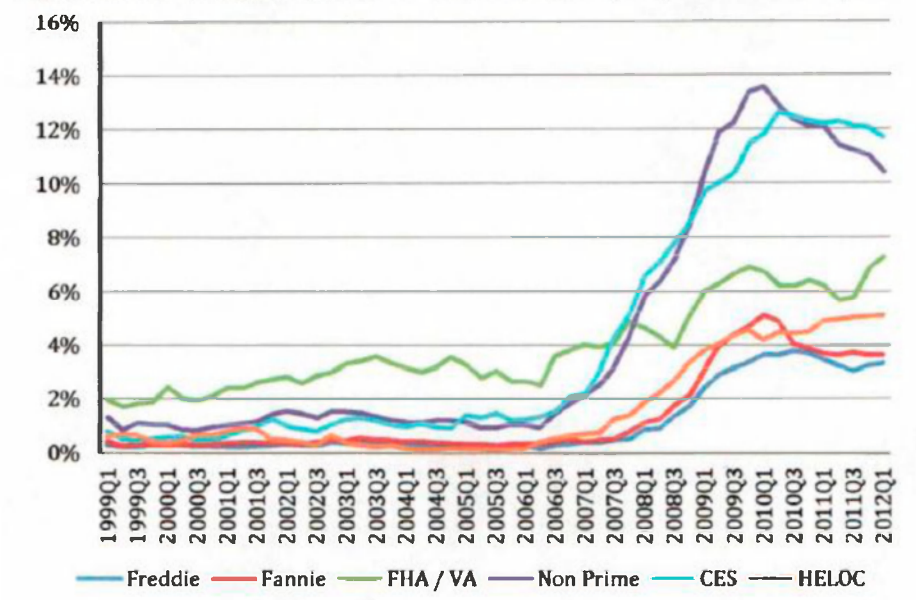
A recent Federal Reserve Bank of New York report establishes this point. The study found that during the housing bubble the bulk of HELOCs were opened well after the borrower

[24] C. Mayer, K. Pence, S. Shurland, Federal Reserve Board Finance and Economic Discussion Series, "The Rise in Mortgage Defaults" 16 (2008).

purchased his or her home, and were not used to finance the down payment.[25] The study also determined that the credit quality of HELOCs was similar to *prime* mortgages, and had similar default rates.[26]

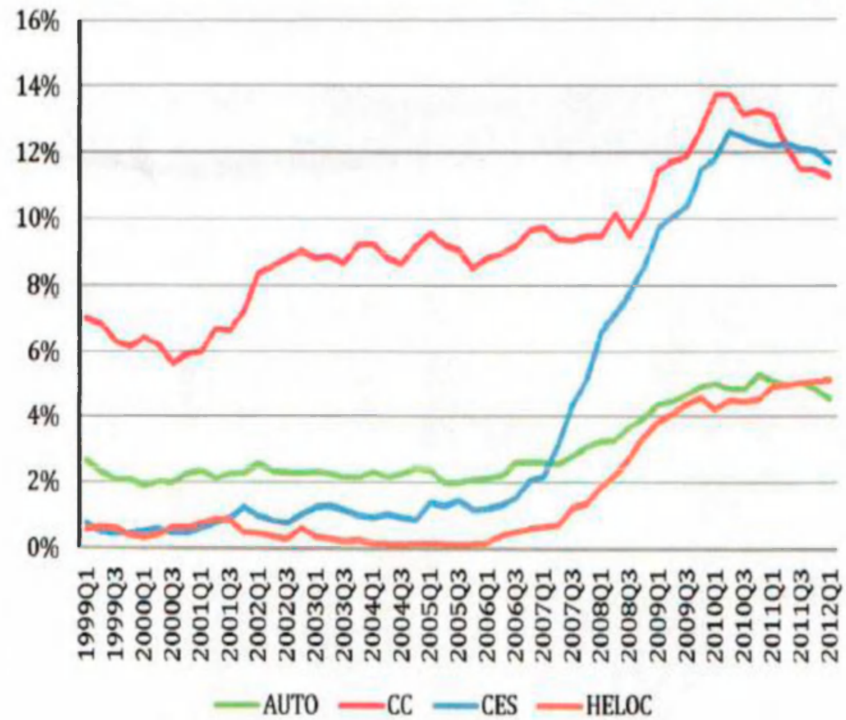
As can be seen from figures 17 and 18 below taken from the Federal Reserve Bank of New York paper, the delinquency rates for HELOCs from 1999 through the first quarter of 2012 tracked closely the delinquency rates for loans purchased by Fannie Mae and Freddie Mac. At their worst, the delinquency rates for HELOCs are essentially the same as the delinquency rates for automobile loans, which under the proposal will be risk-weighted at 100 percent. Second mortgage loans, while not performing as well as HELOCs, had default rates approximately the same as for credit cards at their worst. Credit card exposures are risk-weighted at 100 percent.

Figure 17. 90+ delinquency rates for CES, HELOCs, FHA/VA, Prime and non-prime



[25] D. Lee, C. Mayer, and J. Tracy, "A New Look at Second Liens," Federal Reserve Bank of N.Y. Staff Report No. 569 (Aug. 2012).
[26] Id. at 6.

Figure 18. 90+ delinquency rates for CES, HELOCs, credit cards, and auto loans



Source: D. Lee, C. Mayer, and J. Tracy, "A New Look at Second Liens," Federal Reserve Bank of N.Y. Staff Report No. 569 (Aug. 2012)

Other analyses reached similar conclusions. For example, a study of 135,000 homeowners with second liens or HELOCs originated between 1994 and 2001 found that the default rate on home equity lines of credit was actually less than the default rate on first mortgages.[27] The authors recommended that the regulatory agency should consider reducing the capital charge for HELOCs based on this evidence.[28] A study released in 2010 found that while piggyback loans originated in the bubble years were related to higher foreclosure and default rates, the relationship was limited to subprime piggybacks.[29] The higher default and foreclosure

[27] S. Agarwal, B. Ambrose, S. Chomsisengphet, C. Liu "An Empirical Analysis of Home Equity Loan and Line Performance, *Journal of Financial Intermediation* 15, 444-469 (2006).

[28] "As a rough approximation based on the estimated cumulative 36 month probability of default, we note that a portfolio of home equity lines would require 1 percent less regulatory capital than a portfolio of first mortgages…." Id. at 466.

[29] M. LaCour-Little, C. Calhoun, W. Yu, "What Role Did Piggyback Lending Play in the Housing Bubble and Mortgage Collapse?," J. Hous. Econ. 20(2):81-100 (2011).

rates did not apply more generally to second liens and HELOCs.[30] As pointed out above, the bulk of HELOCs are not associated with piggyback lending, and are generally made to higher quality borrowers.

The risk-weights for HELOCs in the proposal are based on the "unprecedented levels of mortgage loan defaults and home foreclosures" during the recent market turmoil.[31] However, both the financial markets and enhanced government regulation (including the additional oversight from the CFPB) since the financial crisis will restrain the return of poor underwriting and non-traditional lending that led to these high default rates. Moreover, if for any reason an institution does not return to conservative lending practices, the federal banking agencies have at their disposal many supervisory tools to correct the problem, including the ability to establish minimum mortgage underwriting standards and to raise capital requirements on particular institutions based on the bank's risk profile.[32]

The imposition of a risk-weight of up to 200 percent for HELOC and closed-end junior lien mortgage loans would have the odd result of imposing higher capital requirements on secured loans than would be imposed on unsecured loans. For example, a bank making an unsecured personal loan to a consumer who intends to use the funds for home renovation would risk-weight that exposure at 100 percent. The same bank making a second mortgage loan to the consumer for the same amount of funds, and for the same purpose, may have to risk-weight that loan as high as 200 percent, and the issuance of the second loan could then "taint" a first loan held by that same institution. In our opinion, it is very difficult to justify such a result in a risk-based capital framework. This simply does not make sense, yet it is exactly the result that would occur under the proposal.

Furthermore, the agencies have no apparent basis for lumping all HELOCs and closed-end junior liens together and assign the same risk-weight to both exposures. HELOCs and closed-end junior liens have different borrower characteristics, are made for different purposes, and perform very differently in stressed environments. Imposing the same capital charge on these two very different assets is not consistent with the basic principles of a risk-based approach to capital.

The proposal would also unnecessarily burden HELOCs because it would increase the capital charge on the unfunded portion of a home equity line, unless it is cancelable as permitted by law or regulation. Since many people take out a HELOC as a source of liquidity, the undrawn portion of the line can be very significant. This will pose a further adverse effect on banks since

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30 Id. at 2 and 26.

31 77 Fed. Reg. 52888, 52898 (2012).

32 12 U.S.C. § 1828(o) authorizes the agencies to prescribe enforceable standards for real estate lending. 12 U.S.C. § 3907 authorize the agencies to establish minimum capital requirements for individual banks in light of the particular circumstances of that bank.

the result will be a higher capital charge on the unfunded portion of the line in which no interest income accrues.

According to our members, the primary purpose of HELOCs is to finance home improvements, followed closely by debt consolidations. This permits consumers to make structural changes and aesthetic improvements to their homes through low cost financing. The result is not only economic activity and additional jobs in the home construction and improvement sector, but also improves the bank's position by improving the value of the collateral used to support the first mortgage and the HELOC. The second most cited reason for a HELOC is to consolidate debt, typically more expensive debt such as credit card loans. Such consolidation and repayment of more expensive debt is again in the best interests of the consumer and our economy. Consumers also use their HELOCs to pay for future, unforeseen financial emergencies and these are all additional reasons why the proposed treatment of HELOCs and junior lien mortgages needs to be revised.

In short, the proposed treatment of HELOCs and junior liens will dramatically increase the capital cost of these products, which will result in higher interest rates for consumers and potentially make these products less available to homeowners. Raising the capital charge on these products will hurt consumers and, when not associated with piggyback lending, is not justified by the risks to the bank.

E. The Proposal Would Provide a Competitive Advantage to Nonbank Lenders and Foreign Banks

As explained in the introduction, one of the primary goals of risk-based capital is to provide a level playing field so that a lending institution does not gain a competitive advantage due to lower capital requirements. However, the standardized approach proposal would have the opposite effect.

Increasing the risk-weight for Category 1 and Category 2 residential mortgage loans makes these loans more expensive for regulated banking organizations to make. Non-bank lenders are not subject to these capital requirements,[33] and will therefore be able to offer mortgage products at lower rates or with less fees than regulated banking organizations. This will be especially true for HELOCs and second mortgages, where the risk-weights on HELOCs for U.S. banks could be as high at 200 percent, and where a bank holding a first loan may be unable, as a practical matter, to provide a HELOC or second loan to its customer without

[33] The FSOC may designate certain financial companies as Systemically Important Financial Institutions, and thereby impose Federal Reserve regulations, including capital requirements, on them. However, the number of these companies is expected to be relatively small, and the vast majority of non-bank lenders will not be subject to these capital requirements.

adversely affecting the risk-weight of the first loan.[34] Non-regulated lenders have no such concerns, and would be able to provide these products more freely. As a result, this proposal will advantage non-bank mortgage lending, notwithstanding that the majority of poorly underwritten subprime loans were originated by these "shadow banking" institutions.[35]

Another effect of the standardized approach proposal is that it would also advantage foreign banks over U.S. institutions. Under the Basel rules applicable abroad, owner-occupied mortgage loans may be given a risk-weight as low as 35 percent.[36] Further, mortgage servicing rights are generally not generated by foreign banks, and therefore the punitive treatment of these assets would not impact these companies, but would have a detrimental effect on U.S. institutions.

Foreign banking institutions utilizing a 35 percent risk weight for mortgage loans would have a significant advantage over U.S. institutions in making mortgages in the U.S., and will be able to under price their U.S. competitors. This unfair advantage will apply even if a foreign bank operates in the U.S. through a subsidiary bank, since the benefits of the lower risk-weight will be realized at the parent level, even if the subsidiary is subject to our capital regulations.

III. THE PROPOSAL IS NOT CONSISTENT WITH RULEMAKING NORMS IN THAT IT IS NOT BASED ON EMPIRICAL DATA, FAILS TO DISTINGUISH BETWEEN LOANS MADE BY REGULATED BANKS AND LOANS ORIGINATED BY UNREGULATED ENTITIES, AND FAILS TO FULLY TAKE INTO ACCOUNT THE ADDITIONAL REGULATORY CONSTRAINTS ON MORTGAGE LENDING THAT WILL APPLY GOING FORWARD

Under the Administrative Procedure Act, agency regulations may not be "arbitrary or capricious." The courts have interpreted this to mean that an agency must have a rational basis for its rulemakings, including an adequately developed factual predicate for its conclusions. Thus, agency regulations have been struck down when the agency fails to conduct appropriate studies,[37] fails to obtain the appropriate data necessary to make a rational decision,[38] fails to obtain empirical data to support its rulemaking assumptions,[39] or fails to consider the economic consequences of a regulatory proposal.[40]

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[34] The proposal would require the bank to combine both the first loan and the second position, and if the HELOC or second lien does not meet the requirements for Category 1, the entire combined exposure would be treated as a Category 2 loan.
[35] See discussion in section D of this letter, above.
[36] Basel II, paragraph 72 (2006 revision).
[37] Owner-Operator Independent Drivers Ass'n. v. Federal Motor Carrier Safety Administration, 656 F.3d 589 (7th Cir. 2011).
[38] Public Citizen v. Federal Motor Carrier Safety Administration, 374 F.3d 1209, 1221 (D.C. Cir. 2004).
[39] Business Roundtable and Chamber of Commerce of the U.S. v. SEC, 647 F.3d 1144 (D.C. Cir. 2011).
[40] Chamber of Commerce v. SEC, 412 F.3d 133 (D.C. Cir. 2005).

The agencies must base the final capital regulation on factual data and not on mere assumptions regarding the risk of mortgage lending by depository institutions and their holding companies. General data on the performance of mortgages does not relate to the performance of mortgages made by federally regulated banking organizations, and the data about the performance of loans made during the housing bubble does not correlate to the performance of mortgages made under the new regulatory and statutory framework going forward, including the regulatory and supervisory role of the CFPB. It also does not reflect the likely performance of loans meeting the requirements for Category 1.

Prior to promulgating the final rules implementing the Basel II proposal, both the Basel Committee and the U.S. banking agencies conducted a number of "quantitative impact studies" in order to determine what the effect of the proposal would have on the banking industry and the economy.[41] Comptroller Hawke, testifying before Congress, explained that such studies were necessary to inform the rulemaking process:[42]

> As things stand today, we simply *do not have sufficiently reliable information on the effect of these proposals on individual institutions or on the banking industry* as a whole. Before we can make a valid assessment of whether the results are appropriate and acceptable, we have to know, to a much greater degree of reliability than we now have, just what the results of Basel II will be.
>
> The OCC believes that significant additional quantitative impact analysis will be necessary. … I strongly believe that *we cannot responsibly adopt final rules implementing Basel II until we have not only determined with a high degree of reliability what the impact will be on the capital of our banks*, but have made the judgment that the impact is acceptable and conducive to the maintenance of a safe and sound banking system in the United States. [Emphasis added]

We believe that the same holds true today. While the Basel Committee conducted a quantitative impact analysis on the Basel III, the proposed changes to the risk-weights of mortgage loans and HELOCs *are not part of the Basel III agreement*, and therefore no quantitative study has been conducted with respect to these proposals. Applying Comptroller Hawke's reasoning to the current proposal, the agencies should not adopt final rules implementing such significant changes in the capital requirements for federally regulated

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[41] The Basel Committee conducted three quantitative impact surveys, and the U.S. agencies conducted a fourth QIS in the fall and winter of 2005, leading to a decision to delay promulgation of a regulation so that appropriate modifications could be made to reflect the new data. See, "Summary Findings of the Fourth Quantitative Impact Study," February 24, 2006 and the discussion of the results of the fourth QIS at 71 Fed. Reg. 55830, 55837 et. seq. (2006).

[42] Testimony of Comptroller John Hawke Before the Senate Committee on Banking, Housing and Urban Affairs, Hearing on the New Basel Capital Accord, 108th Cong. 1st Sess. 8 (2003).

banking organizations without first determining, to a high degree of reliability, what the impact will be on our banks, financial system, and economy.

Any adjustments to risk-weights must be rationally related to the findings. For example, it is simply not appropriate for the agencies to decide that second loans and HELOCs present some added risk, and therefore *double* the risk-weights of these assets. Rather, the agencies must explain a logical connection between the amount of increased risk and the amount of the change in the risk-weight. Simply deciding to add 50 percent or 100 percent in additional risk-weight because those numbers may "seem about right" is not sufficient under the law and is certainly not consistent with public policy.

Finally, in light of the likely economic harm that will be caused by an increase in risk-weights, the agencies have a responsibility to consider all reasonable alternatives to the proposed change in capital charges, and provide a thoughtful explanation of why those alternatives were not accepted.

IV. THE PROPOSAL WILL IMPEDE THE SECURITIZATION OF MORTGAGE LOANS, WILL HAMPER THE REINVIGORATION OF A SECONDARY MARKET FOR NON-CONFORMING LOANS, AND WILL ENCOURAGE THE GROWTH OF FANNIE MAE AND FREDDIE MAC AT THE EXPENSE OF PRIVATE CAPITAL

A. Private Mortgage Backed Securities are Significantly Disadvantaged

Private label mortgage-backed securities (securities issued without a government agency or GSE guarantee) are significantly disadvantaged. Under the standardized approach NPR, a bank holding such securities would have to assign it a risk-weight of 1,250 percent, unless the bank can demonstrate, to the satisfaction of its examiner, that it has a comprehensive understanding of the structure and risks of the security. To demonstrate this understanding, the bank is required to conduct an analysis of the material features of the securitization, such as the cash flow waterfall, triggers, credit enhancements, and the specific definitions of default used in the securitization. The bank must consider relevant information about the performance of the underlying securities; market data; price volatility; trading volume; liquidity support; percentage of loans that are 30, 60 and 90 days past due; loans in foreclosure; overall default rates; occupancy data; average LTV of the underlying loans; average credit scores of the borrowers; the extent of the geographic diversification of the loans and the size, depth and concentration of the market for the securitization, including bid-ask spreads. Based on the bank's analysis, the appropriate risk-weight for the security would be determined using one of two prescribed models in the regulation.[43]

[43] Banks can use either a "gross up" approach or the simplified supervisory formula approach. Under the gross up approach, the bank holds capital against its position, and also holds capital for all of the more senior positions supported by the bank's position. Under the simplified supervisory formula approach, the bank supplies various

Most banks in the U.S. simply do not have the capacity or sophistication to undertake such a detailed analysis of a mortgage backed security. Therefore, they will be unable to purchase private label mortgage backed securities, and instead purchase Fannie Mae and Freddie Mac instruments, which are automatically assigned a risk-weight of 20 percent. The result will be the additional growth of these two GSEs. The market for non-conforming loans will suffer, and the cost of these mortgages will increase or will disappear in their entirety. This result is inconsistent with the important public policy goal of reducing the role of the GSEs and having private capital become the primary source of mortgage finance while bearing the risks of loss.[44] The proposal will also add costs for banks that originate mortgages and wish to fund future originations by selling their mortgage portfolio into a securitization structure. Under the "Minimum Regulatory Capital Ratios, Capital Adequacy" NPR, the selling bank must deduct from its tier 1 regulatory capital any non-cash gain on sale that would be recognized under generally accepted accounting principles, and apply a risk-weight of 1,250 percent to any credit enhancing interest only securities generated by the securitization.

In order to avoid these adverse consequences, we recommend that the agencies find another method to distinguish the risk presented by private label MBS. For example, the agencies could stratify the risk presented by private label MBS by an easily obtainable metric, such as the average FICO score of the borrowers, percent of the loans that are made to prime borrowers, or average LTV of the pool.

B. Mortgage Servicing Rights

Mortgage servicing rights (MSR) are assets created when the right to service a mortgage is separated from the underlying loan. These assets typically arise in connection with mortgage securitization, when loans are sold into a securitization vehicle but the servicing is either retained by the selling bank or transferred to a third party servicing "specialist." However, MSRs may also arise in the non-securitization context when a bank decides that it would be more efficient to transfer the servicing to an institution that has the existing technical capability and servicing infrastructure to service loans. Banks wishing to engage in servicing activities in order to maintain a close relationship with their customers may decide that they need to acquire additional servicing rights in order to have the necessary volume to support the acquisition of the necessary infrastructure.

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inputs in a formula developed by the agencies. The inputs include such factors as the risk weights of the underlying assets, the attachment and detachment points, the current amount of delinquencies, and enhancements.

[44] See, e.g. U.S. Departments of the Treasury and HUD, Reforming America's Housing Finance Markets: A Report to Congress (Feb. 2011)(The Administration's goal is to shrink the GSEs and for private capital to become the primary source of mortgage credit and bear the burden of loss); Center for American Progress testimony before the House Subcommittee on Capital Markets and Government-Sponsored Enterprises, Nov. 3, 2011 (private capital must play a much greater role in the mortgage market and the role of the GSEs should be reduced). Similar sentiments have been expressed by Republican leadership as well as independent academic experts.

The proposed treatment of mortgage servicing rights is draconian. Pursuant to the "Minimum Regulatory Capital Ratios, Capital Adequacy" NPR, all servicing rights in excess of 10 percent of a bank's common equity tier 1 capital must be deducted from capital. The assets that are not deducted are given a risk-weight of 250 percent under the standardized approach NPR.

There appears to be no debate that MSR is a valuable asset that has benefits for banking organizations as they provide cash flows, and may be sold in a liquid market. Thus, these assets support a bank's other activities and contribute to its financial health.[45] Driving this asset out of the banking system will greatly *decrease* the number of companies able and willing to perform this activity, and thereby raise the cost of servicing for the public. It will force customers to use unknown providers and will also deprive regulated financial companies of a stream of revenue that can be used to support other lending activities. The net effect will be to make loan securitization more expensive and thereby increase the cost of mortgage loans. Further, mortgage servicing companies *outside* of the regulated banking industry will become the major providers of this service, and valuable mortgage servicing assets will have to be sold to these companies at significant discounts. We have already been advised by some of our members that several large servicers have begun to curtail their correspondent channels, thereby reducing outlets for smaller originators, and decreasing the number and price of market bids for servicing. Targeting mortgage servicing rights also creates disparity between U.S. banks and foreign banks as the latter have few, if any, mortgage servicing rights.

The CBA appreciates that mortgage servicing assets lost value as a result of the large number of defaults and foreclosures stemming from the housing bubble, and the related litigation over foreclosure procedures. However, for the reasons discussed above, we believe that the housing financial markets have already and will continue to underwrite mortgage loans in a conservative manner. We urge the agencies to reconsider the very punitive treatment of mortgage servicing rights in the proposals, and suggest a cap on these assets be retained at 100 percent of tier 1 capital, and that they should be assigned a risk-weight of 100 percent.

C. <u>Securities Held As "Available for Sale"</u>

In the "Minimum Regulatory Capital Ratios, Capital Adequacy" proposal, banking organizations would be required to recognize in their capital account unrealized gains and losses in securities held as "available for sale" (AFS). Since the market value of mortgage backed

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[45] See, e.g., Testimony of FDIC Chair Sheila Bair, Hearing on Implementing the Dodd-Frank Act, Before the Senate Comm. on Banking, Housing and Urban Affairs, 111th Cong. 2d Sess. 67 (2010)(While the value of mortgage servicing rights can be volatile, they clearly have value.); Testimony of Federal Reserve Board Tarullo, Hearing Before the Subcommittee on Security and International Trade of the Senate Comm. on Banking, Housing and Urban Affairs, 111th Cong. 2d Sess. 16 (July 20, 2011)(Mortgage servicing rights, again, are not the same as an asset already on the balance sheet, but they are an expected stream of earnings which have performed well in the past.)

securities varies with changes in market interest rate, this proposal will cause significant swings in the capital levels of regulated institutions, based on fluctuations in interest rates.

In addition, although the value of interest rate sensitive assets held AFS will fluctuate with interest rates, the bank's capital ratios will not reflect offsetting changes in the value of liabilities used to fund these assets, or the value of many hedges against interest rate movements. It is for these reasons that changes in the market value of AFS securities have not been reflected in a bank's capital ratio, unless the value of the security has been determined to be other than temporarily impaired. This is will make it harder for banks to manage risk, as their capital levels will be subject to constant fluctuation. It is likely that some lenders will seek to reduce the size of their securities portfolios in order to minimize this risk, putting further downward pressure on the mortgage market through reduced pricing of MBS. Before a change with these consequences is made, we believe that it is incumbent upon the agencies to explain clearly the rationale for the change, and to consider fully any other alternatives that would have less deleterious effects.

V. THE PROPOSAL SHOULD NOT APPLY RETROACTIVELY

It is critically important that any change in the risk-weights applied to mortgage loans or mortgage-backed securities should not be applied retroactively. According to FDIC data, insured depository institutions hold approximately $1.875 trillion in closed-end residential mortgage loans, $580 billion of funded HELOCs, and $1.7 trillion in mortgage-backed securities.[46]

If the risk-weight for mortgage assets are retroactively increased by an average of 50 percent, insured depository institutions would have to absorb a $62 billion reduction in capital, assuming that banks wish to attain a 10 percent capital ratio. If the average increase in risk-weight is higher, the resulting loss in capital would be proportionately higher. On top of this are increased capital charges for mortgage-backed securities, first mortgages paired with HELOCs, high velocity commercial real estate, and mortgage servicing rights. The capital hit to institutions based on assets already on their books will be punitive, and the repercussions will be felt throughout the economy.

Applying the new risk-weights retroactively is likely to motivate many institutions to sell these mortgage assets into the market. However, since the rules apply to all insured depository institutions and their holding companies, the number of sellers will greatly outnumber the companies seeking these assets. The result will be extremely depressed prices that will depress the real estate markets, and lower the perceived fair market value of mortgages. Banks that choose not to sell into this depressed market will likely offset the increased capital burden by shrinking, thereby further decreasing the amount of funding available for all loans. There is no

[46] FDIC, Quarterly Banking Profile (June 30, 2012).

apparent public policy rationale for retroactive application of higher capital charges, and clear public policy reasons not to do so.

In addition to the reasons discussed above, retroactive application may also be impossible from a practical standpoint. Under the proposal, the risk-weight to be applied to mortgage assets depends on whether the loan meets the requirements for Category 1. Among other things, Category 1 requires that the underwriter make a determination that the borrower has the ability to repay based on prescribed factors, including "documented, verified income." In many cases, it may not be possible to determine, years after a loan is made, whether the underwriting process took into account all of the required factors for Category 1.

VI. CONCLUSION

The regulatory proposals will have a significant, negative impact on mortgage lending in the United States. The results will be higher mortgage financing costs, less mortgage availability, and competitive advantages for non-regulated lenders and foreign banks not subject to these new capital requirements. The proposals will undermine the goals of the Federal Reserve Board in its recently announced "QE III" which is designed to lower mortgage rates and thereby spur economic recovery. Excessive capital charges on mortgages will have a negative impact on consumers, and will hamper efforts to reduce unemployment. Adverse effects will be spread throughout our economy, since housing is a key catalyst for the growth in businesses both large and small.

The proposals heavily favor the GSEs over privately issued mortgage securitizations, thus helping to defeat the public policy goals of shrinking Fannie Mae and Freddie Mac and bringing private capital into mortgage finance. The securitization of non-conforming loans, which is essential for the recovery of the housing markets, would be penalized under these proposals, thereby providing another barrier to the recovery of the housing markets.

Many of the proposed regulatory changes appear to be based on general assumptions about risk rather than supporting data. In particular, we believe that the factual and analytic foundation has not been appropriately developed for the proposed changes regarding first and second residential mortgages and lines of credit. In addition, the required factual foundation has not been established for the proposed changes in the accounting treatment of AFS securities, the limitation on mortgage servicing rights, and the new rules to be applied to private label mortgage-backed securities. In sum:

- There is no clear indication that the proposals took into account the extensive new laws and rules that have been adopted, or will be adopted in the near future.

- There is no clear indication that the agencies took into account the market forces that have caused mortgage underwriting standards to reach new levels of stringency, and have made the sale of private label mortgage-backed securities extremely difficult.
- There is no clear indication that the agencies took into account the adverse economic impacts that these regulatory proposals would have on our economic recovery, on first time homebuyers, or on low- and moderate income communities.
- There is no clear indication that the proposal carefully analyzed the impact of loan structure and loan terms as the primary causes of the high defaults we witnessed during the financial crisis, and the extent to which those structures and terms are no longer possible, or would not be possible for Category 1 loans.

Under rulemaking norms, it is incumbent upon the agencies to propose regulations that reflect a careful analysis of all of the relevant factors. Therefore, we urge the agencies to reconsider these proposals after conducting the necessary studies and QIS-like surveys needed to understand fully both the likely risks associated with mortgage lending going forward, and the economic and social impact of making mortgage lending more expensive and mortgage credit less available.

Thank you for the opportunity to comment on the proposals, specifically the impact on the mortgage markets. If you have any questions or require any additional information, please do not hesitate to contact me at (202) 552-6366 or by email at jbloch@cbanet.org.

Sincerely,

Jeffrey P. Bloch
Associate General Counsel