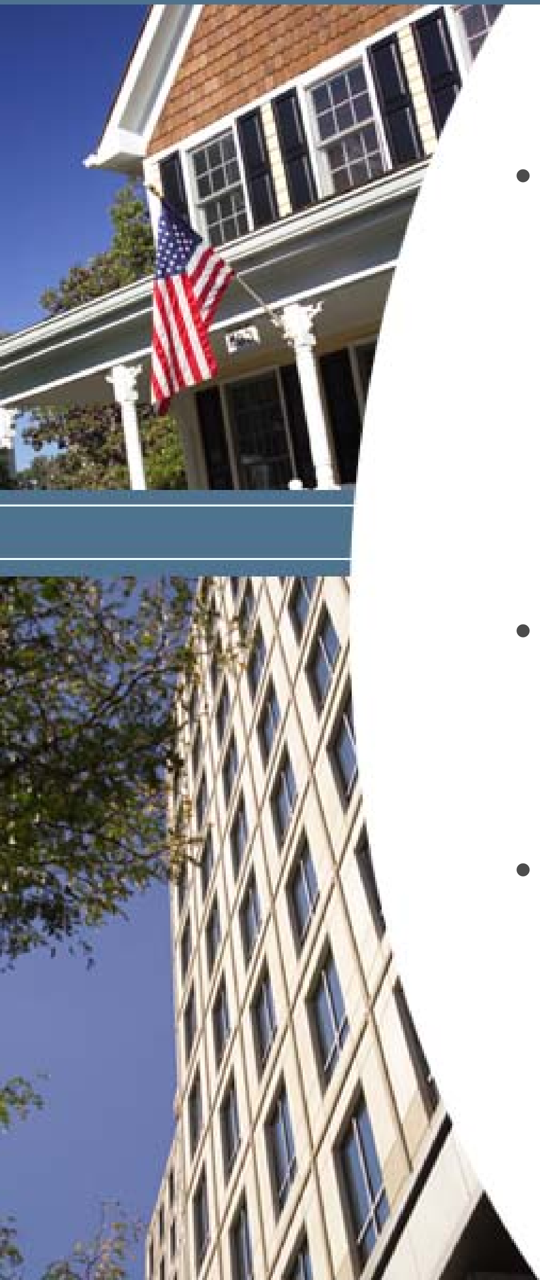
Basel III and the Impact on the American Homebuyer and the Mortgage Market

Why Federal Regulators Must Pull Back on the Basel III Proposal

MORTGAGE BANKERS ASSOCIATION®
Investing in communities

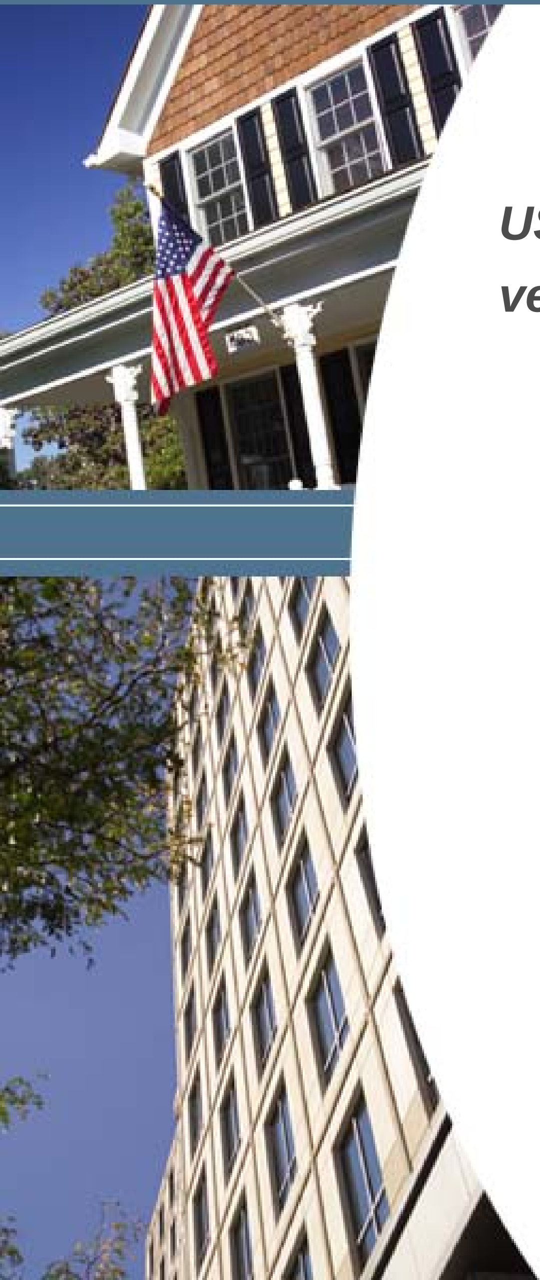
What is Basel and Basel III?



- The Basel Committee for Banking Settlements (BCBS), which meets in Basel Switzerland, is an international organization that has established the Basel Accords to bring about uniformity of capital standards for banks worldwide.

- Basel III is the third significant issuance of guidance from the BCBS.

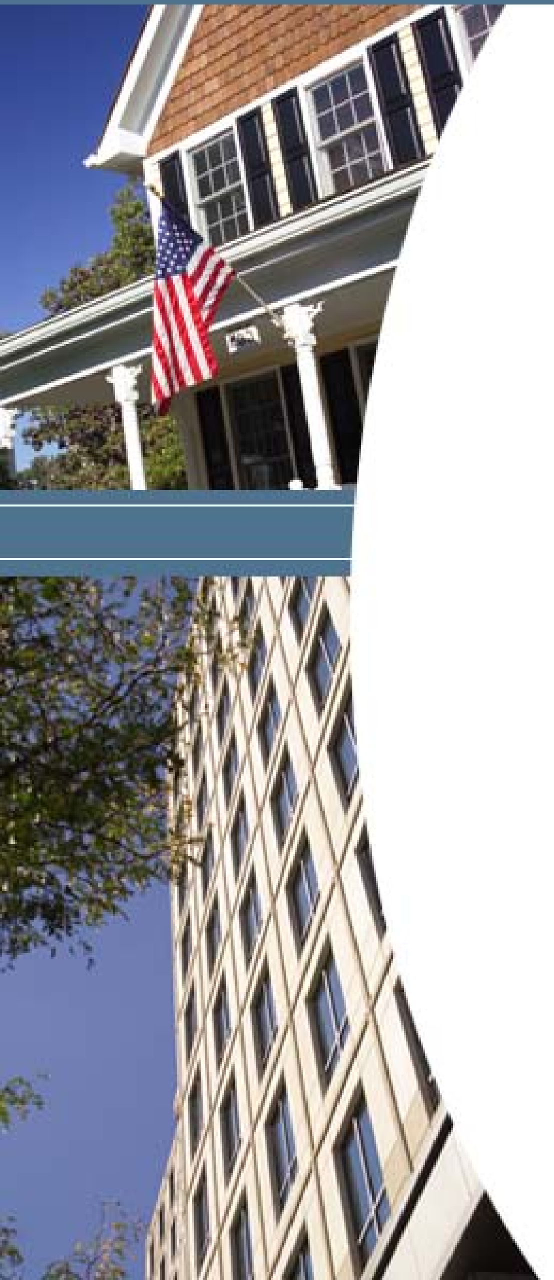
- Each participating banking system is encouraged to implement the guidance as part of their regulatory system.



US banking regulators have proposed to implement a version of Basel III that would:

- **Adversely impact credit availability to consumers**
- **Adversely impact pricing to consumers**
- **Put US banks on an unlevel playing field compared to its international competitors**
- **Stifle real estate finance when layered-in with other proposed regulations**
- **Skew the market to higher risk products like unsecured loans**

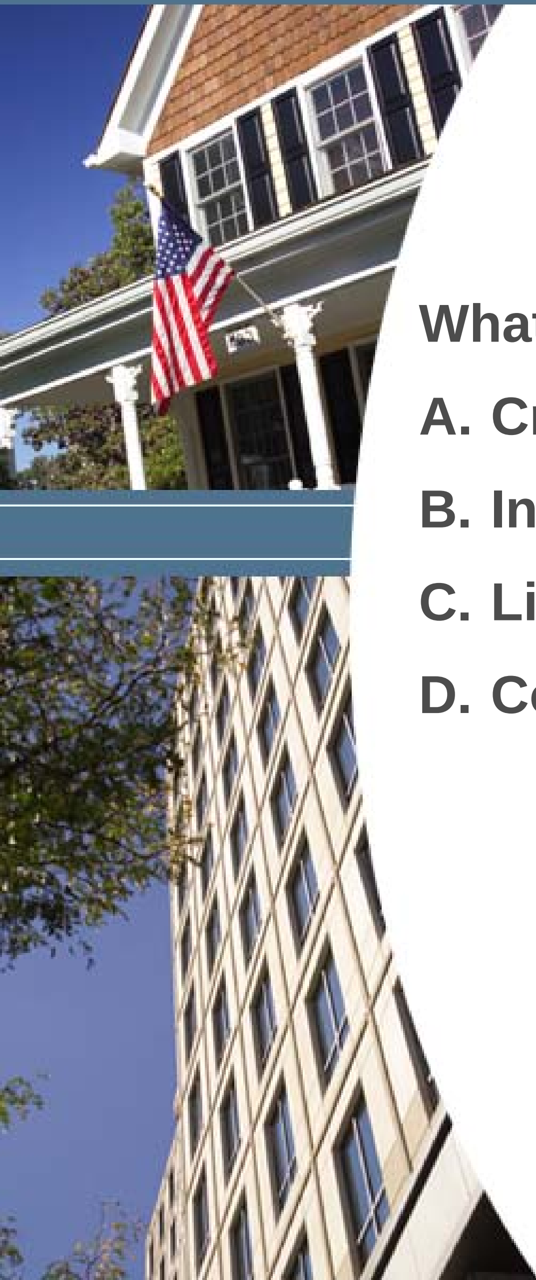
Example of a Bank Balance Sheet



Bank ABC
Balance Sheet as of 9/30/12

	(000's)
Assets:	
Cash	$ 15,000
Residential mortgages	200,000
Credit card receivables	50,000
Commercial loans	100,000
Mortgage servicing rights	15,000
Other assets	10,000
Total assets	$ 390,000
Liabilities and Capital:	
Deposits	$ 345,000
Other Liabilities	5,000
Total liabilities	350,000
Capital:	40,000
Total Liabilities and capital	$ 390,000

Key Bank Risks



What are the key risks faced by a bank?

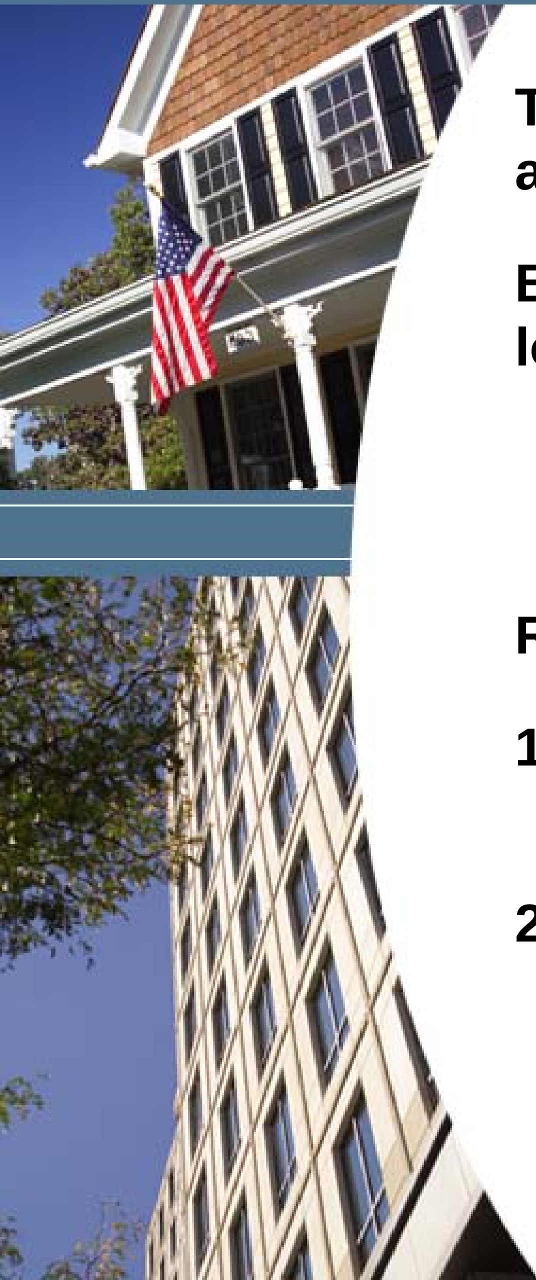
A. **Credit Risk** – *being repaid for loans*

B. **Interest-Rate Risk** – *changes in expected returns*

C. **Liquidity Risk** – *ensuring sufficient assets to pay debts*

D. **Counterparty Risk** – *doing business with third parties*

Importance of Bank Capital



The FDIC is a back stop for consumer bank accounts.

But someone else stands in front of the FDIC and loss on a bank:

> ***Capital!*** **The shareholders who hold the capital take a hit before the FDIC insurance fund does.**

Risk-based capital is used by regulators to:

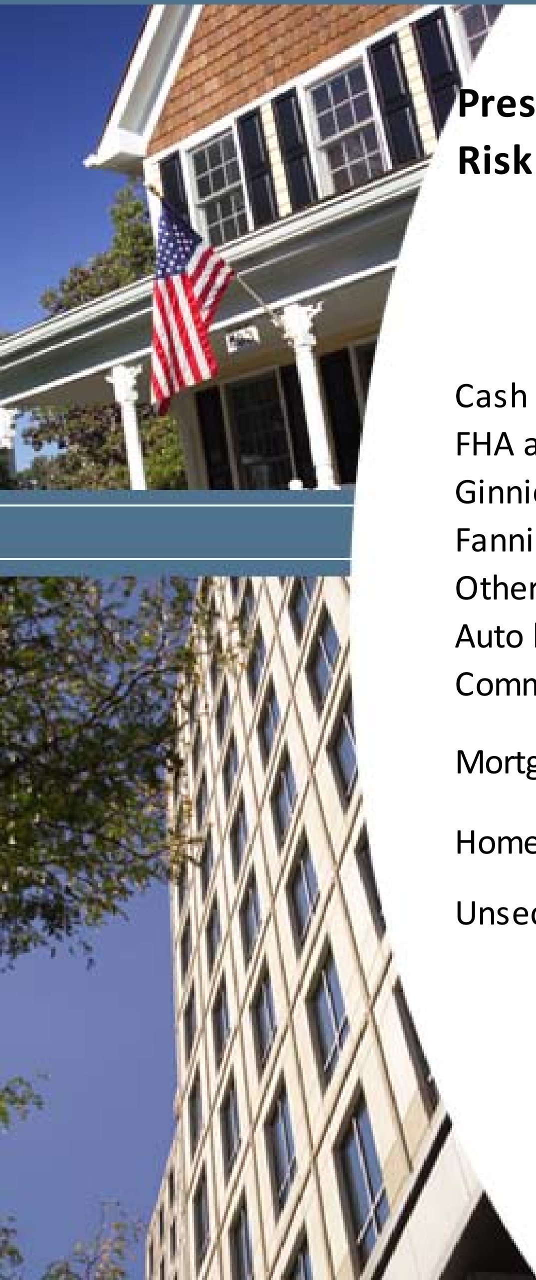
1. **Require more capital for higher risk assets using risk weighting**
2. **Evaluate capital adequacy relative to risk weighted assets**

Risk-based Capital Ratio

Capital/ Risk-weighted assets

The higher the ratio,
the stronger the bank.

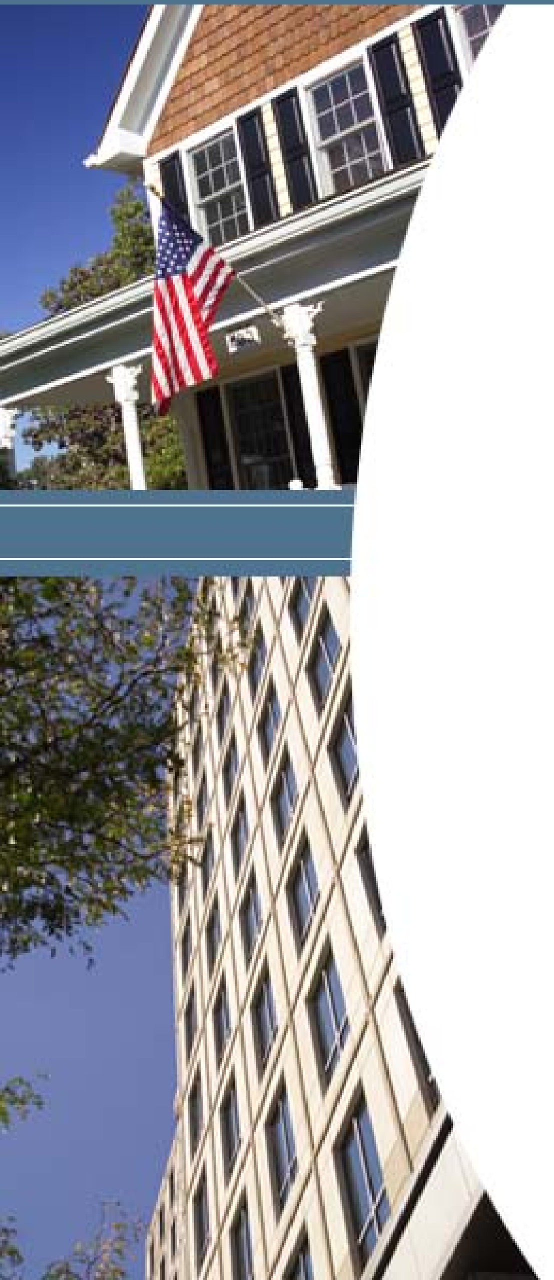
Hierarchy of Risk Weightings



Present Risk-Based Capital Rules
Risk Weight Examples

Asset	Present Risk Weight	Risk Profile
Cash on hand and in Federal Reserve	0%	Liquid and no credit risk
FHA and VA loans	0%	Express U.S. Government guarantee
Ginnie Mae MBS	0%	Express U.S. Government guarantee
Fannie Mae and Freddie Mac MBS	20%	Implied U.S. Government guarantee
Other residential mortgage loans	50%	Collateralized by real estate
Auto loans	100%	Collateralized by depreciating collateral
Commercial Loans	100%	Can be unsecured or collateralized
Mortgage servicing rights	100%	Senior in cash flow waterfall, marketable, but subject to prepayment risk.
Home Equity Loans	100%	Junior lien on real estate
Unsecured loans to individuals	100%	Loan based on credit history and character of borrower

Using Today's Risk-weights



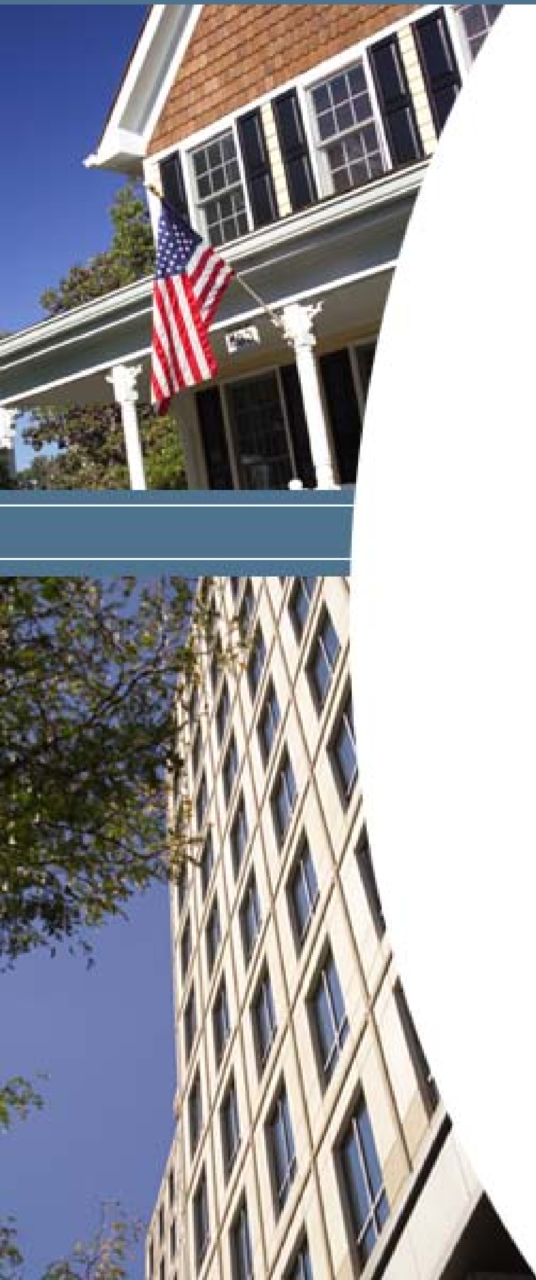
Bank ABC
Balance Sheet as of 9/30/12

	(000's)	Risk Weight	Risk Weighted
Assets:			
Cash	$ 15,000	0%	$ -
Residential mortgages	200,000	50%	100,000
Credit card receivables	50,000	100%	50,000
Commercial loans	100,000	100%	100,000
Mortgage servicing rights	15,000	100%	15,000
Other assets	10,000	100%	10,000
Total assets:	$ 390,000		$ 275,000
Liabilities and Capital:			
Deposits	$ 345,000		
Other Liabilities	5,000		
Total liabilities	350,000		
Capital:	40,000		
Total Liabilities and Capital:	$ 390,000		

Well capitalized bank!

NUMERATOR	**$ 40,000**
DENOMINATOR	**$ 275,000**
Risk-based capital ratio	**14.55%**

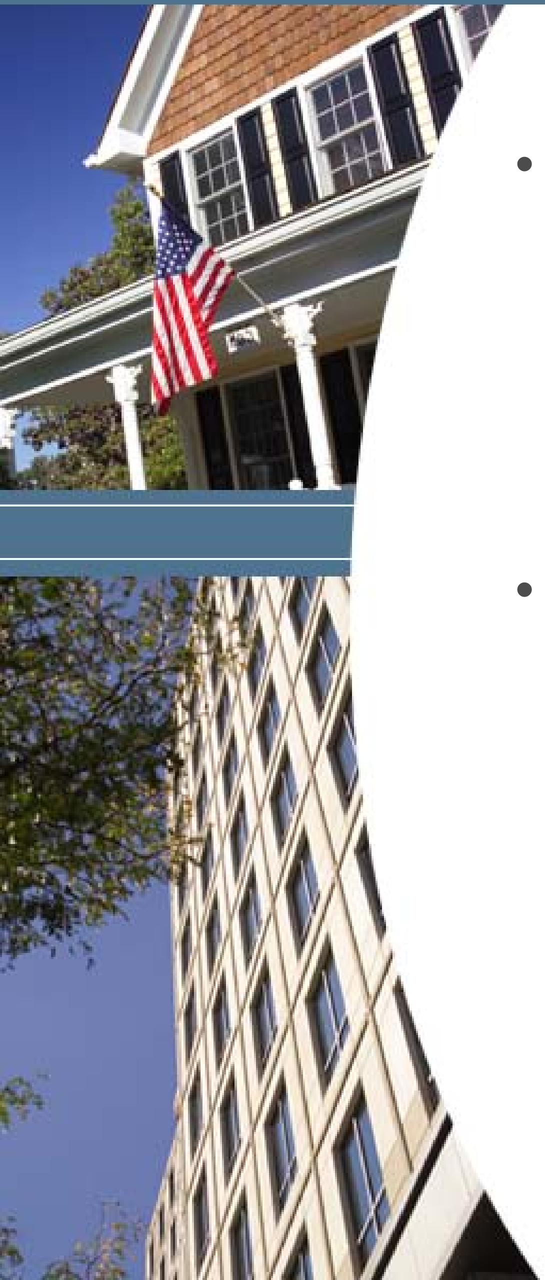
Proposed U.S. and European Commission Risk-weights



Present Risk-Based Capital Rules
Risk Weight Examples

Asset	Present Risk Weight	U.S. Basel III Proposed Risk Weight	European Commission Basel III Proposal
Cash on hand and in Federal Reserve	0%	0%	0%
FHA and VA loans	0%	0%	0%
Ginnie Mae MBS	0%	0%	0%
Fannie Mae and Freddie Mac MBS	20%	20%	20%
Other residential mortgage loans	50%	35% to 200%	35%
Auto loans	100%	100%	75%
Commercial Loans (small business)	100%	100%	75%
Mortgage servicing rights	100%	250%	250%
Home Equity Loans	100%	100% to 200%	100%
Unsecured loans to individuals	100%	100%	75%

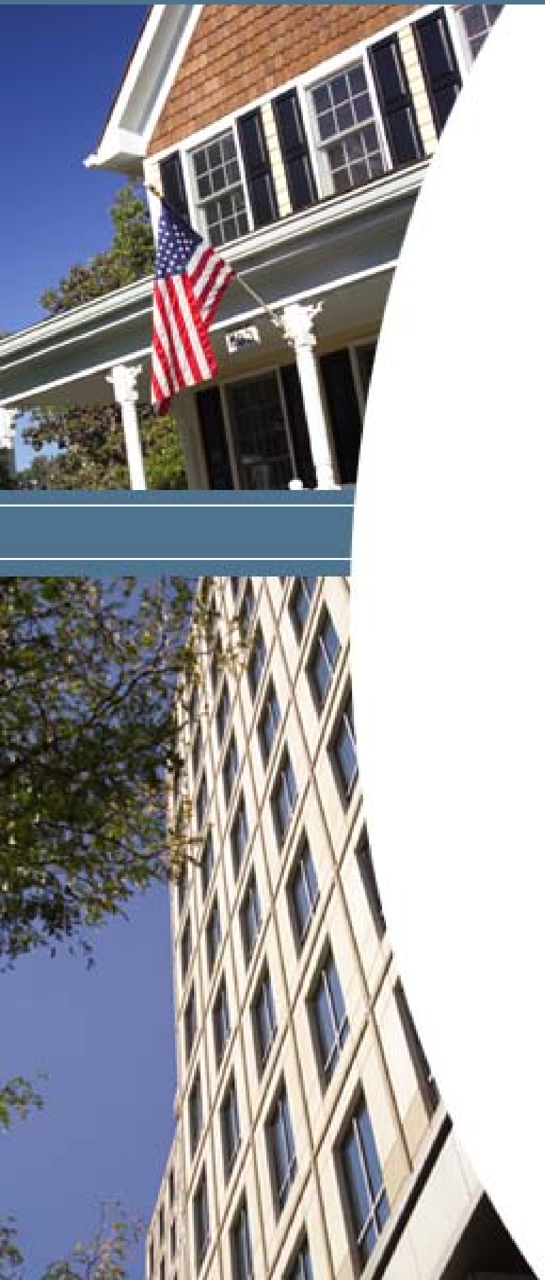
Observations on Proposed Risk Weights



- The US version of Basel III appears to be diverging from standards in Europe – targeting specifically the real estate finance industry and products.

- Improper risk weighting will skew the marketplace by incentivizing irrational decisions concerning assets and liabilities. This could lead to a preference toward unsecured consumer and business loans versus well-secured residential mortgage loans.

Same Bank, New Rules



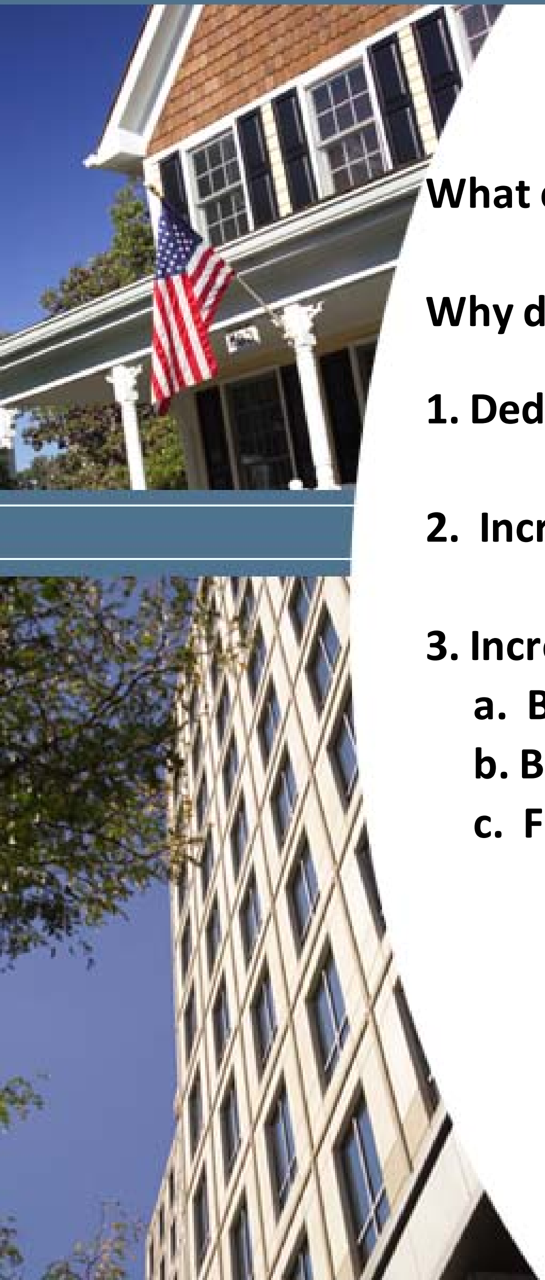
Bank ABC
Balance Sheet as of 9/30/12

	(000's)	Deduction from Equity	After Deductions	Risk Weight	Risk Weighted
Assets:					
Cash	$ 15,000		$ 15,000	0%	$ -
Residential mortgages	200,000		200,000	100%	200,000
Credit card receivables	50,000		50,000	100%	50,000
Commercial loans	100,000		100,000	100%	100,000
Mortgage servicing rights	15,000	(11,000)	4,000	250%	10,000
Other assets	10,000		10,000	100%	10,000
Total assets	$ 390,000		$ 379,000		$ 370,000
Liabilities and Capital:					
Deposits	$ 345,000				
Other Liabilities	5,000				
Total liabilities	350,000				
Capital:	40,000	(11,000)	$ 29,000		
Total Liabilities and Capital:	$ 390,000				

NUMERATOR	**$ 29,000**
DENOMINATOR	**$ 370,000**
Risk-based capital ratio	**7.84%**

The risk-based capital ratio is under 8.0% and so the bank is now under-capitalized!

How Did the Bank Go From Well-capitalized to Under-capitalized?



What changed?

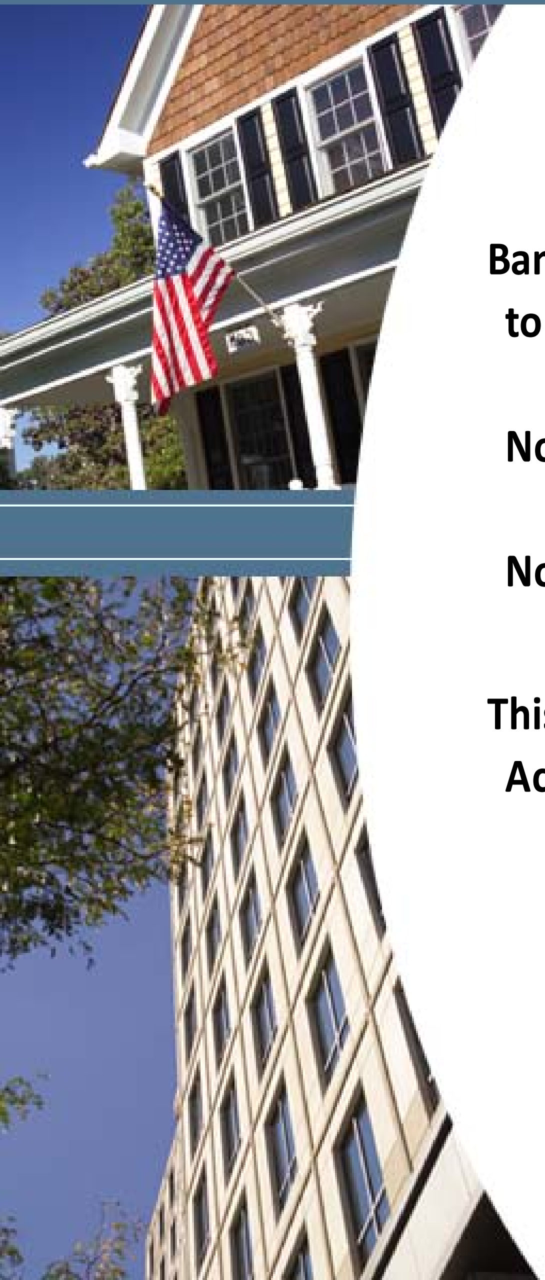
Why did risk-based capital drop from 14.55% down to 7.84%?

1. Deduction of a portion of MSRs directly from capital.

2. Increasing risk weighting of MSRs not deducted from capital.

3. Increasing the risk-weighting of residential mortgage loans:
- **a. Beyond the risk-weighting of unsecured consumer loans**
- **b. Beyond the risk-weighting of unsecured business loans**
- **c. Far beyond the risk-weighting that the European Union banks will use**

Bank Examiners at the Door!



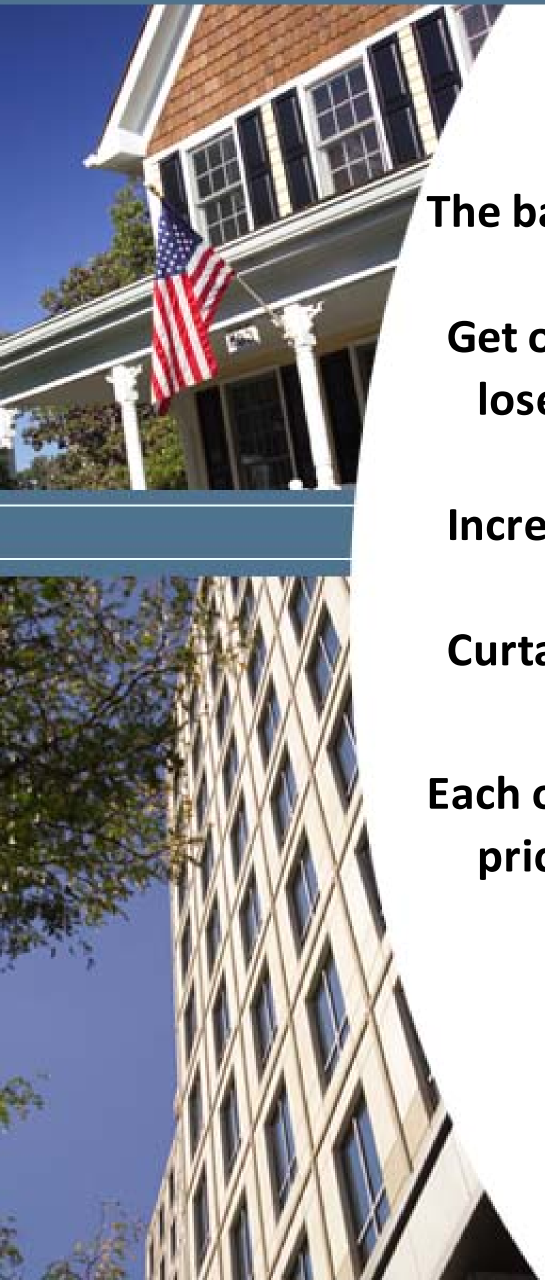
Bank would move from being "well capitalized" to "undercapitalized" with:

No change in the make-up of the balance sheet

No change in the risk-profile of the bank

This will prompt the chain of regulatory regimes for "Prompt Corrective Action"

Likely Bank Reactions

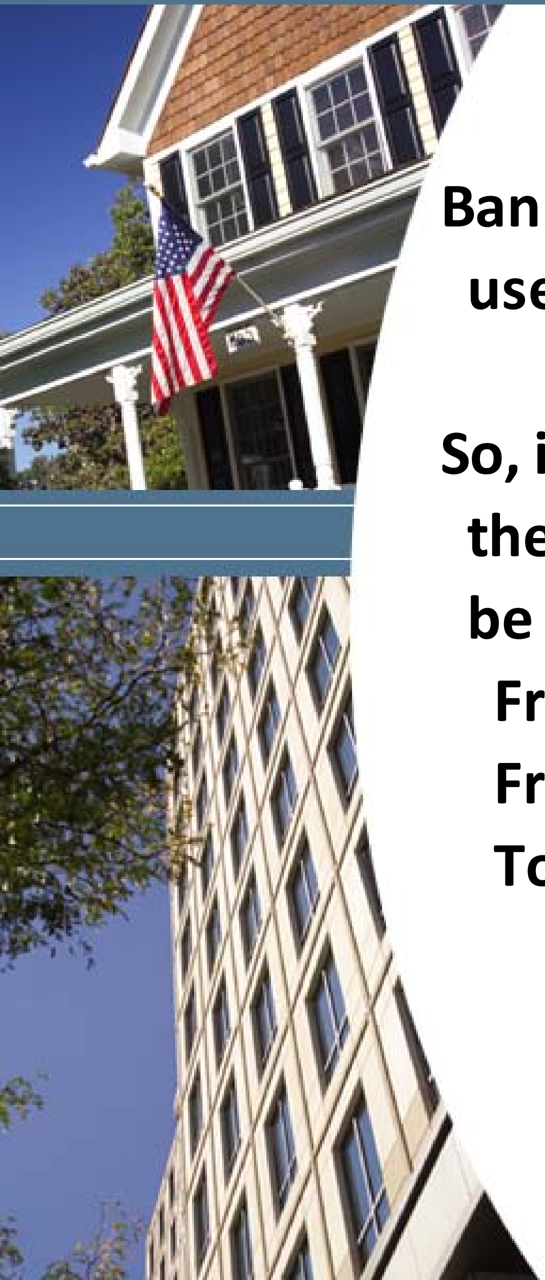


The bank would likely:

- **Get out of the mortgage servicing business and lose that important connection with its retail customers**
- **Increase pricing of residential mortgage loans to consumers**
- **Curtail lending to shrink the balance sheet**

Each of these could adversely impact service, credit availability or pricing of residential mortgage loans to consumers

Bank Pricing 101

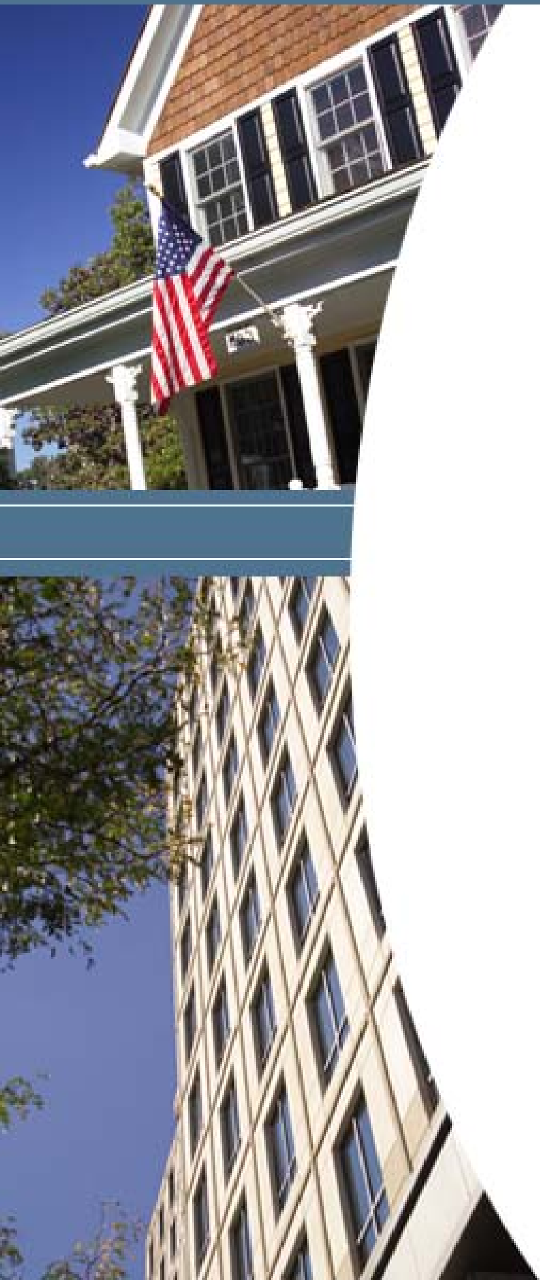


Banks generally price loans based upon their use of the scarce resource -- capital

So, if a loan requires 8 percent of capital under the risk-based capital regime, then the loan would be assumed to be financed:

From deposits	92%
From capital	8%
Total	100%

Impact to Customer – Category 1 Mortgage



Impact on Consumer of Change in Risk-Weighting of Residential Mortgage Loans

Current capital requirements

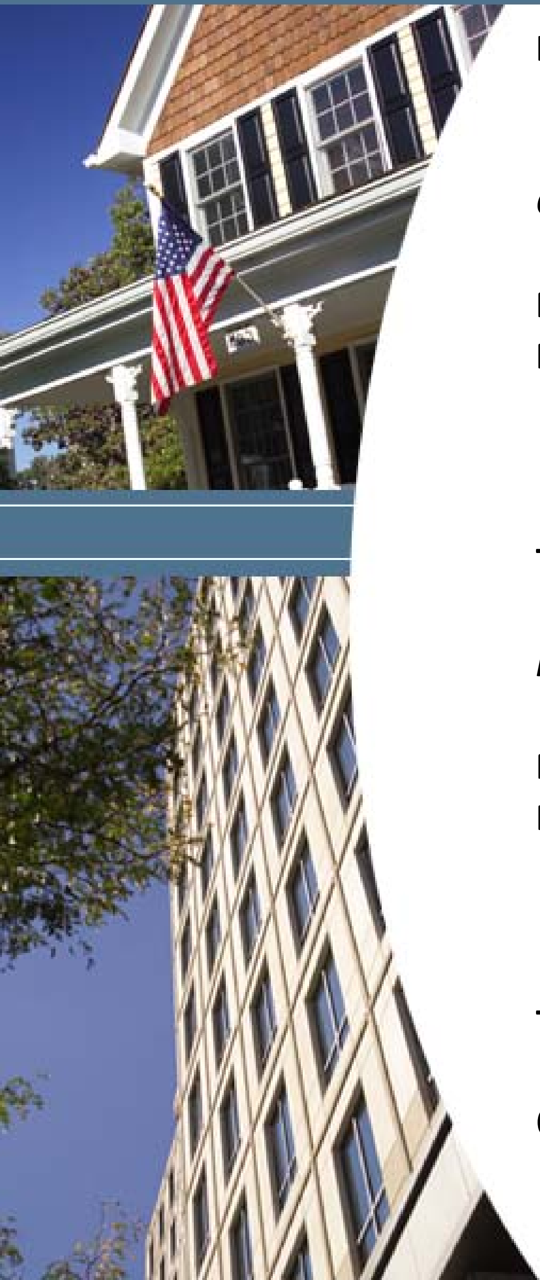
Mortgage (95 LTV with MI, category 1 loan)	**$100**	
Funded with:		**At cost of:**
Deposits	**$96**	**2%**
Capital (50% risk weight, 4% capital)	**$4**	**15%**
Total cost of funding		**2.52%**

Proposed Basel III risk weights

Mortgage (95 LTV with MI, category 1 loan)	**$100**	
Funded with:		**At cost of:**
Deposits	**$92**	**2%**
Capital (100% risk weight, 8% capital)	**$8**	**15%**
Total cost of funding		**3.04%**

Change in price to consumer **0.52%**

Impact to Customer – Category 2 Mortgage



Impact on Consumer of Change in Risk-Weighting of Residential Mortgage Loans

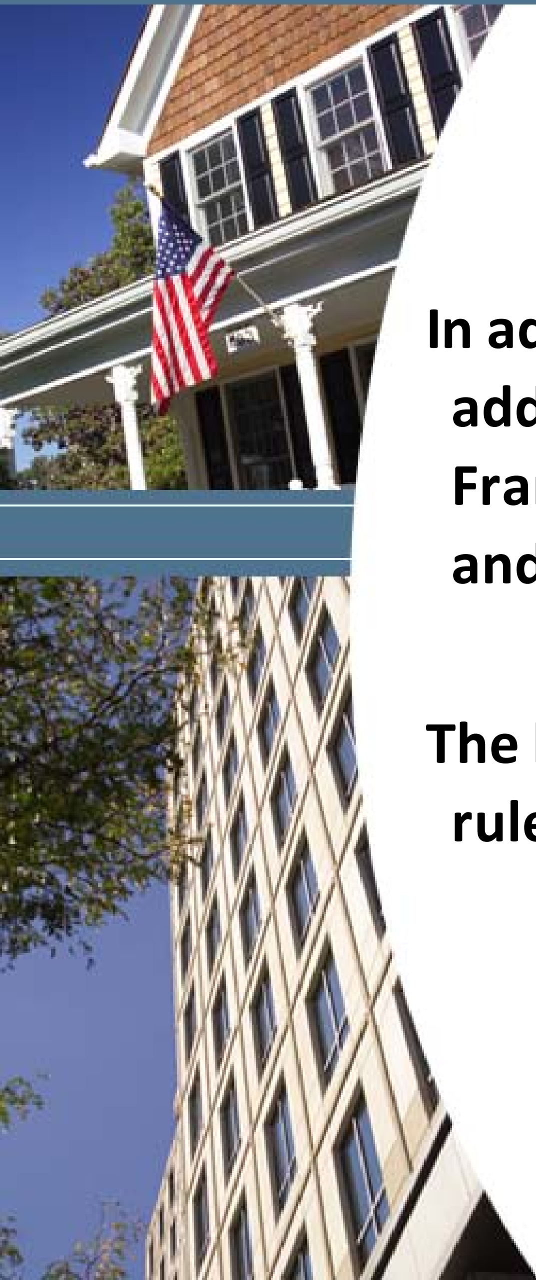
Current capital requirements

Mortgage (95 LTV with MI, category 2 loan)	$100	
Funded with:		At cost of:
Deposits	$96	2%
Capital (50% risk weight, 4% capital)	$4	15%
Total cost of funding		2.52%

Proposed Basel III risk weights

Mortgage (95 LTV with MI, category 2 loan)	$100	
Funded with:		At cost of:
Deposits	$84	2%
Capital (200% risk weight, 16% capital)	$16	15%
Total cost of funding		4.08%

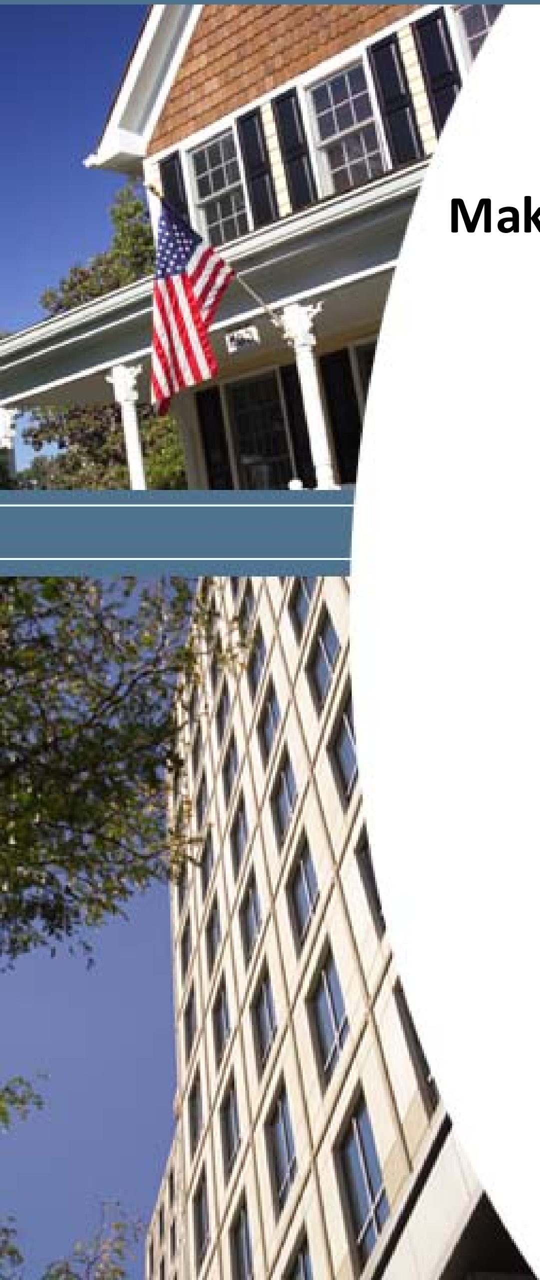
Change in price to consumer **1.56%**



In addition to Basel III, U.S. banks are contending with the added uncertainties of major rulemakings under Dodd-Frank, including QM and QRM, major changes to RESPA and TILA, and proposed national servicing standards.

The layering of Basel III on top of other new or proposed rules will stifle real estate finance.

Remember the Community Bank?



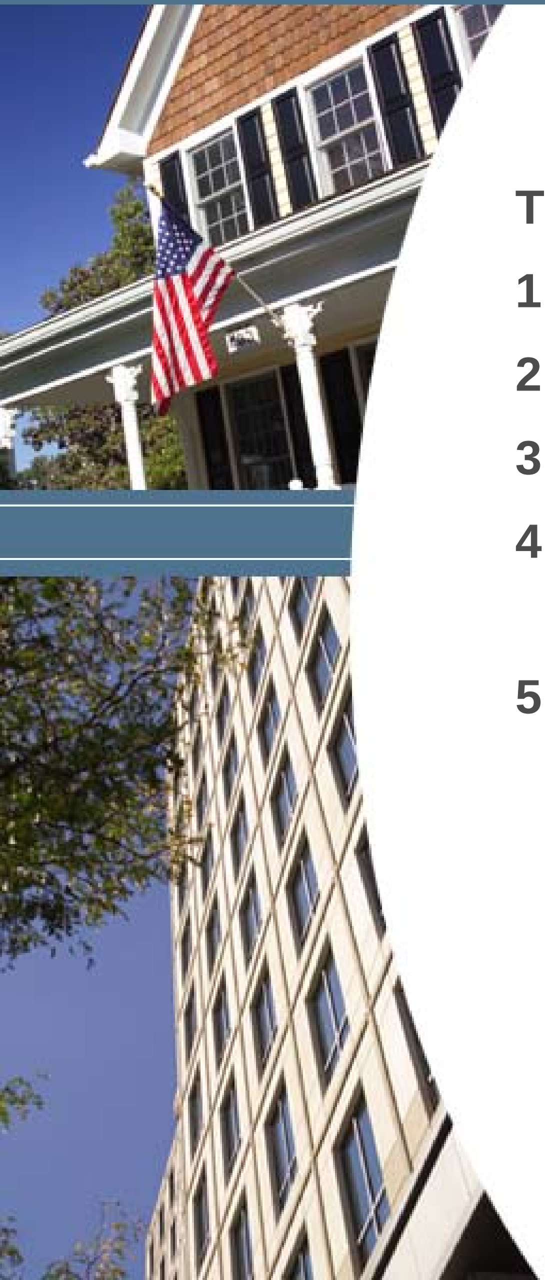
Making it difficult for small, community banks to compete:

Huge cost of creating infrastructure for Basel III

Negative impact of onerous capital rules for real estate finance

Small banks don't have the same level of access to capital markets to bolster capital post Basel III

Summary of Impacts



The US Version of Basel III would:

1. **Adversely impact credit availability to consumers**
2. **Adversely impact pricing to consumers**
3. **Put US banks on an unlevel playing field**
4. **Stifle real estate finance when layered in with other proposed rules**
5. **Skew the market to higher risk products like unsecured loans**