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**SUBJECT: Comments on the Risk-Based Capital Guidelines  
Implementation of the New Basel Capital Accord**

Ladies and Gentlemen:

The Mortgage Bankers Association (MBA) welcomes the opportunity to comment on the August 4, 2003 Advance Notice of Proposed Rulemaking (ANPR) concerning the risk-based capital guidelines for the proposed New Basel Capital Accord (Basel II).

MBA commends the Office of the Comptroller of the Currency, the Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation and the Office of Thrift Supervision for their efforts to promote the safety and soundness of real estate investments and mortgage-backed securities under the Basel II framework. Sound financial institutions boost investor confidence and encourage prudent capital flow. Because MBA actively encourages both market liquidity and judicious underwriting practices, our comments will focus on balancing the proposed capital treatment of various categories of loans and mortgage-backed securities with the need to meet real estate industry liquidity and underwriting goals, recognizing that inappropriate weights could adversely affect investment in communities and economic vitality, both in the United States and elsewhere. Our comments also address specific questions posed in the August 4, 2003 ANPR.

## Background on MBA and the U.S. Real Estate Finance Industry

MBA is the national association representing the U.S. real estate finance industry. Headquartered in Washington, D.C., the association works to ensure the continued strength of the nation's real estate markets; to expand homeownership prospects through increased affordability; and to extend access to affordable housing to all Americans. MBA's membership of 2,700 companies includes all elements of residential real estate finance: mortgage companies, mortgage brokers, commercial banks, thrifts, the issuers of private residential mortgage-backed securities (RMBS) and others in the home mortgage lending field.

MBA is also the leading representative of America's \$1.8 trillion commercial real estate finance industry. MBA's constituency includes the commercial banks and thrift institutions which represent the single largest source of capital for U.S. commercial real estate, as well as the issuers, servicers, bondholders and administrators of commercial mortgage-backed securities (CMBS), which provide secondary market liquidity to America's commercial real estate sector. MBA and its members are committed to the vibrancy of U.S. commercial real estate finance industry and wish to see the final Basel II guidelines support the health of this sector.

The savings of most Americans are invested in deposit accounts at American banks, including commercial banks and thrift institutions, who in turn invest those funds in mortgages, mortgage-backed securities and other lending vehicles. In addition, life insurance companies and pension funds are key investors in the \$332 billion CMBS market, which is backed by commercial real estate loans. Therefore, the financial security of average Americans, including small depositors, the policyholders of life insurance companies, pensioners and other small investors, is broadly affected by the security and liquidity of the real estate debt market. MBA is committed to representing these consumers by promoting the safety and vitality of real estate lending, on both the commercial and residential fronts.

MBA members have raised the following concerns about Basel II, including its proposed implementation in this country, for the commercial/multifamily real estate sector and for the single-family sector as discussed in detail below.

## Implications of Basel II and the ANPR to Commercial and Multifamily Lending

MBA supports the use of international guidelines that can be flexibly interpreted by national banking authorities. MBA believes that the risk rating system proposed under the draft Basel II standard assigns excessive risk weights to certain loan categories based on historic performance data. In this context, MBA observes that the capital set-aside requirement for life insurance companies with respect to commercial real estate loans in good standing averages approximately 1.92% according to staff at the National Association of Insurance Commissioners -- considerably below the 4%-6% standard anticipated for the highest quality commercial real estate loans under the proposed Basel II framework. Life insurance companies and commercial banks compete for

mortgage transactions. The heavier capital reserve requirements for commercial real estate lending proposed under Basel II may therefore erode the competitive position of commercial banks relative to life insurance companies in the commercial real estate finance realm.

Land acquisition, construction and development loans for single-family housing are included in the high volatility commercial real estate (HVCRE) category (in which "Good" to "Satisfactory" loans carry risk weights of 125% to 175%), despite the fact that the historical default rates on such loans are well-below commercial real estate averages and are more similar to those associated with mortgages for owner-occupied one- to four-family housing (to which the draft Basel standards assign a 35% risk weight). Similar evidence is presented in a June 2003 white paper authored by the U.S. Board of Governors of the Federal Reserve System, which notes that asset default correlations for single-family land acquisition and construction loans are substantially below those for other types of commercial properties. MBA therefore recommends that one- to four-family land acquisition, construction and development loans be moved to the income-producing real estate (IPRE) category, which uses slightly lower risk weights (100% to 150% for "Good" to "Satisfactory" loans).

On balance, MBA believes that the proposed risk weights for core commercial property types—that is, multifamily, office, industrial and retail—are too high, especially for IPRE loans. MBA's members note that a disproportionate number of commercial real estate loan defaults come from the hotel and health care sectors, and that loss severity for hotel and health care credits is also higher than for multifamily, office, industrial and retail loans. Accordingly, MBA recommends that the Bank for International Settlements (at the international level) and/or U.S. banking authorities (with respect to American requirements) refine the Basel II risk weights to reduce requirements for multifamily, office, industrial and retail loans.

As proposed under the draft Basel framework, MBA concurs that national banking authorities should be permitted to reclassify land acquisition, construction and development loans that are significantly pre-sold or pre-leased to tenants with satisfactory credit profiles. MBA's members have suggested that a significant pre-leasing standard be linked, for newly-originated loans in good standing, to that level of pre-leasing needed to achieve a 1.0x debt service coverage ratio (DSCR). [The DSCR is the ratio of net operating income to annual debt service.] Similarly, loans could be moved from the HVCRE class to the IPRE class upon the attainment of a leasing level sufficient to produce a 1.0x DSCR. Typically, properties achieve a 1.0x DSCR when they are approximately 70% to 75% leased, although the leasing percentage can vary according to property type, rents and expenses, as well as the credit's loan-to-value ratio.

An alternative, slightly more conservative approach that is particularly relevant in situations when the construction lender is not offering permanent financing or mini-perm financing, might be to link the pre-leasing standard needed to achieve the DSCR

required by the property's permanent lender. The required DSCR is typically specified in the take-out agreement (which typically precedes the construction loan), and is set by market conditions. When market conditions are less robust, the takeout DSCR for multi-family properties is typically in the 1.20x for multifamily credits and 1.25% for office, retail and industrial credits. When market conditions are stronger and competition among permanent lenders is keen, the required DSCR may decline to the 1.05x to 1.15x range.

MBA suggests that DSCR tests be applied using the higher of a loan's (a) fixed or maximum hedged interest rate, or (b) such other debt service constant used by the lender in its underwriting.

MBA believes that commercial real estate ADC loans that are pre-sold should be moved to the IPRE class. As noted previously, we recommend that single-family ADC loans be categorized as IPRE. MBA does not recommend any further adjustment of single-family ADC risk weights based on the sales progress of the project. Most single-family ADC loans are made on a recourse basis that is not linked to the sales progress of the project. Lenders for non-recourse single-family ADC credits often require earnest money deposits or, less frequently, contractual commitments from homebuyers, before construction funds are advanced to the builder. These credit practices do not lend themselves to further risk weight adjustment based on the sales progress of a particular project.

It is uncertain whether the Basel II framework sufficiently considers the customary practice of employing credit enhancements to bolster the credit quality of commercial real estate loans when assigning risk weights. MBA suggests that banking regulators be required to consider credit enhancement vehicles that have proven to be effective in decreasing risk when assigning risk weights. Specifically, residential and nursing home loans backed by FHA guarantees (which guarantee the lender against 99% of loss) should be associated with reduced capital set-asides. MBA concurs with the suggestion in the current ANPR that private mortgage insurance be considered fully as a factor associated with lower loss reserve requirements. With respect to commercial properties, reduced capital set-asides should accompany loans backed by borrower guarantees or tenant rental guarantees sufficient to ensure loan repayment or, in the case of tenant guarantees, a 1.0x or better DSCR. Borrower guarantees or tenant rental guarantees can include pledged assets, lines of credit or letters of credit.

Finally, the Basel II standards should *require capital set-asides only for at-risk capital, rather than for the full loan amount. This principal should extend to all credits for which the lender is responsible for only a portion of principal risk.* For example, the Fannie Mae Delegated Underwriting and Servicing (DUS) program requires the lender to absorb only a small portion of any loss on multifamily loans originated, and Basel II capital reserves should be required only against the DUS lender's actual exposure.

### Implications of Basel II and ANPR to Single-Family Residential Mortgage Lending:

Generally, MBA believes the 35% risk weight assigned to qualifying residential mortgage loans under the Standardized Approach in Basel II acknowledges that the 50% risk weight assigned to such loans under Basel I is excessive. MBA believes that this is particularly true in the U.S. where credit losses from qualifying residential mortgage loans are often covered entirely by mortgage insurance. We therefore strongly recommend that the banking regulators follow the lead of the Basel II architects by amending the existing capital regulations to ensure that "general banks" in the US (i.e. those banks that would continue to be subject to Basel I and existing regulations) will be able to assign a risk weight of 35% or lower to their qualifying residential mortgage loans. We believe this change will help to ensure that "general banks" in this country are not placed at a disadvantage with respect to their residential lending activities vis a vis A-IRB banks and foreign banks that adopt the Standardized Approach.

More generally, we support the Agencies' approach in furthering the Basel II effort to more closely align economic and regulatory capital. We perceive our member institutions to be driven to a greater extent by economic capital considerations as opposed to regulatory capital. Having said this, a significant disparity between the two creates intraorganizational stress and potential for "capital arbitrage" that is wasteful and counterproductive. The efforts by the agencies to reduce this disparity will help institutions of all sizes. With regard to competitive considerations between large and small institutions, we believe preserving the option for smaller banks to opt-in to the A-IRB approach is critical. If any competitive disparities between large and small institutions were inadvertently created through the new capital regime, we would expect the marketplace to address these disparities by selling the appropriate expertise and potentially the operational implementation to smaller institutions, allowing them to correct any such disparity. We see no reason why this "entry cost" into the A-IRB approach should be prohibitive.

MBA also believes that the proposed 10% Loss Given Default (LGD) floor and 15% Asset Value Correlation (AVC) factor for residential loans are not empirically-based and are therefore excessive, resulting in regulatory capital charges significantly in excess of A-IRB bank's economic capital requirements. As a result, the proposed implementation of Basel II will on a relative basis discourage residential lending among A-IRB institutions.

The MBA further believes that, as noted in a recent study conducted by the Risk Management Association (RMA), the AVC values remain too high relative to industry practice for mortgage assets. Implementation of this AVC would also unfairly discourage the holding of mortgage assets relative to other assets. We believe a lower mortgage AVC consistent with the RMA study is appropriate.

Our responses to several specific questions posed by the Agencies in the ANPR for comment are provided below:

With regard to the recognition of PMI for LGD, a data-driven approach to LGD estimation should capture the impact of PMI and, for that matter, government mortgage insurance or guarantees. Imposition of an arbitrary 10% floor on mortgage LGD is unnecessary and contrary to empirical risk determination. This would unduly and inappropriately discourage institutions from holding mortgages; consequently, we do not believe a floor should be imposed, irrespective of PMI considerations. Having said this, any exclusion from such a floor would be a positive development and PMI protection would seem to provide the most appropriate exclusion. Again, we believe that a data-driven approach is the most sound, robust and stable means for appropriate capital regulation.

We do not see or believe there are any significant competitive implications to PMI recognition. This assessment flows from the broad application of PMI by all firms originating mortgages, the universal PMI requirements imposed by market-making institutions, and the competitive nature of PMI pricing in the marketplace.

With regard to risks associated with residential mortgage exposures generally, we believe the credit risks associated with holding prime first mortgages are well understood. The data history on this product is long-standing and robust, making Probability of Default (PD) and LGD predictable within a very small margin of error by utilizing ever more advanced statistical techniques and technology.

Although the data is somewhat less broad and deep for home equity loans and lines, this small disadvantage is offset in the nature of home equity lending, which is based more on ability to repay (cash-flow lending) than on collateral (equity lending). The robust nature of credit history analysis as applied in the credit card industry greatly assists firms in estimating home equity PD, which is of greater significance than LGD in this type of lending.

Non-prime mortgages constitute a much smaller market than either of the above. Credit risk is significantly more operative, given the lack of consistent historical credit standards and the resultant relative lack of data for building predictive models. These aspects are reflected in both the securitization structures common to this asset and the more direct risk management role of non-prime mortgage underwriters. Securitization agreements and trustees require close monitoring of delinquencies and defaults, along with the related cash or collateral funding of the sub-structures required to protect bondholders. Credit risk management is further aided by the relatively short life of non-prime mortgages, driven by the strong pricing incentives for the mortgagor to reduce cost by improving his credit grade at the first opportunity.

With regard to any housing price bubble or mortgage credit shortage, we see no real evidence of either phenomenon. Given the predictability of mortgage defaults as discussed above, capital requirements for prime mortgage and home equity lending of

less than one percent appear appropriate. This predictability emphasizes EL and thereby minimizes UL, indicating appropriately low credit risk capital levels for these assets. We believe such a level would be accurate and would not, therefore, have any significant negative competitive implications. On a relative basis at least, the regulatory oversight of the GSEs and the dramatic expansion of their mortgage holdings in recent years would seem significantly more problematic with regard to any extension of the federal safety net than this alignment of economic and regulatory capital. Given the significant expansion of mortgage risks taken on by the GSEs, we have seen and would expect no evidence of a mortgage credit shortage.

We believe mortgage assets and MBS are arguably the safest possible assets for regulated institutions to hold from a credit risk standpoint, relative to minimizing the federal government's exposure. Mortgage loans as a whole have a very long and robust data history, providing the raw material for creation of accurate default predictive models with an outstanding record of accuracy over a long period of time. This has resulted in very low delinquency and default rates for mortgages as against other assets. It also drives the vast majority of losses, such as they are, into EL as opposed to Unexpected Loss (UL). Given that capital is designed to compensate for UL, which we strongly support, this further appropriately assesses credit risk and reduces government exposure. Residential MBS are even safer in that they have, unlike any other asset, as many as six sources of repayment: the mortgagor, government guarantee or PMI, the house itself, the seller/servicer, the GSE and any pool insurance. To best protect the government's interest, regulatory capital requirements should encourage to the extent possible regulated institutions towards holding the safest and most credit-manageable assets: in our view, mortgages and MBS.

#### Real Estate Securitization Issues Suggested by Basel II

MBA's members are pleased that the proposed Basel II framework allows lenders a variety of approaches, including reliance on external or internal ratings, to calculate capital set-asides for commercial and residential mortgage-backed securities. MBA's members eligible for the use of the proposed A-IRB standards value the opportunity to use flexible methods to determine appropriate capital set-asides and agree that institutions should be able to rely either on external ratings-- the foundation on which mortgage-backed securities are evaluated, priced and traded—loan mapping, or internally-generated inferred ratings.

In addition, MBA suggests the following revisions in the risk-based capital guidelines for mortgage-backed securities under Basel II:

Substantial reduction of the recommended capital set-aside for mortgage-backed securities (MBS). The 56 basis point minimum capital set-aside for CMBS and RMBS is excessive for AAA and AA rated issues or tranches, which typically are associated with default rates of considerably below 1%. With respect to CMBS, the proposed Basel framework overstates the risk associated with CMBS, relative to collateralized debt

obligations (CDOs). MBA recommends that the federal agencies rely on CMBS loss experience data that pertain specifically to CMBS.

A-IRB originators of CMBS should not be required to deduct from capital securitization exposures at or below KIRB in circumstances where such exposures are rated. We believe the disparate treatment of exposures held by originators of CMBS -- versus investors in CMBS -- is unjustified in circumstances where the exposures held by both banks are rated. We urge the banking authorities to conform the treatment of originating and investing banks in these circumstances.

With respect to unrated positions above K-IRB, the proposed deduction method is too harsh and penalizes institutions for holding CMBS. It is our understanding that the Basel Committee plans to revise the proposed Supervisory Formula Approach for unrated securities. MBA believes that both A-IRB originators and investors should be permitted to develop internal ratings approaches or to apply external ratings, when appropriate, to determine capital set-aside standards.

With respect to the proposed Ratings-based Approach, MBA notes that external ratings typically consider the granularity and tranche thickness of the underlying issues. Thus, external ratings take into account the risks associated with holding thin or less-granular tranches. The imposition of additional risk criteria based on tranche thickness and granularity might therefore overstate the risk of holding the affected securities. Because originators more frequently hold below-investment grade pools, MBA has a concern that such treatment might adversely affect the originators of CMBS and market liquidity.

MBA observes that the Ratings Based Approach need not make any adjustment for loan maturity, as all CMBS issues are routinely re-evaluated and re-rated over the life of the securities. Thus, external ratings remain fresh.

Treatment of CMBS originators and investors for non-A-IRB institutions: MBA feels that originators and investors should be treated identically, to ensure that neither group is penalized under the Basel framework. MBA believes that both originators and investors should be able to use a variety of approaches to determine capital set-aside standards, and believes that financial institutions should be permitted to choose either the Ratings Based Approach or the Alternative Ratings Based Approach, based on the judgment of the financial institution.

MBA concurs with the proposed risk weighting of 0 for recoverable servicing advances, funds for which are disbursed extremely conservatively and pose virtually no repayment risk. Recoverable servicing advances for CMBS securitizations have first claim on all cash flows from the underlying loan pool.

#### Study to Evaluate Whether Improved Practices Have Materially Reduced Default Rates and Correlations

There is considerable evidence to suggest that the use of enhanced underwriting standards, practices and technologies and the growing influence of the secondary markets, including the standards set by rating agencies and growing information



transparency, have materially reduced since the mid-1990s commercial real estate loan default rates and the default correlations for commercial real estate loans.

- The July 2003 Standard and Poor's study documents declines in U.S. commercial real estate loan default rates that parallel a period of improvement in U.S. underwriting practices and technologies, including the adoption of more stringent appraisal standards, the growing use of underwriting standards established by the secondary market rating agencies, and the introduction of lease-based valuation software.
- The U.S. Board of Governors of the Federal Reserve, in a June 2003 White Paper, also has reported time-series data showing declines in asset default correlations for commercial real estate loans since the mid-1990s, both in absolute terms and relative to commercial and industrial credits. Industry participants suggest that these declines mirror improvements in underwriting practices and technology that have accompanied the growth of secondary market securitization, the adoption of more stringent appraisal and valuation standards, and the introduction of lease-based valuation software. These developments appear to have improved market transparency and the sophistication of underwriting models, with the effect of reducing commercial real estate credit risk.
- Delinquency and default data compiled by Fitch Ratings and JP Morgan Securities also suggest that commercial real estate delinquencies and defaults are at materially lower levels than in previous real estate cycles.

MBA believes that a federal study is warranted to determine whether these trends have been associated with declines in asset default correlations and delinquency and default rates. If this is the case, further reductions in proposed Basel II capital set-asides for commercial real estate credits would be warranted. MBA supports a multiple regression or other appropriate study to shed light on this important issue and would recommend that such a study be completed in time to influence the U.S. implementation of Basel II by federal banking regulators.

#### Incentives for Non-A-IRB Lenders who Adopt Exemplary Underwriting Standards, Practices and Technologies

The proposed A-IRB standards recognize and reward the underwriting and credit management sophistication of the largest financial institutions. MBA believes that the final Accord and its regulatory implementation in the U.S. should also offer concrete incentives for non-A-IRB real estate lenders to adopt high-quality underwriting practices and technologies. To this end, MBA recommends that the final Accord establish preferential risk weights—or permit national banking authorities to do so—for all real estate credits in good standing which utilize exemplary underwriting standards, practices and technologies. Precedent for this approach is found in the American


mortgage-backed securities industry, in which the practices, procedures and technologies used by loan servicing firms are evaluated when ratings are assigned.

MBA believes that the introduction of preferential capital standards for the use of exemplary underwriting standards, practices and technologies would encourage non-A-IRB banking entities across the globe to carefully underwrite, value and monitor their commercial real estate credits through the use of state-of-the-art underwriting standards, practices and techniques.

MBA and its member financial institutions look forward to continuing to work with the Basel Committee, BIS, U.S. banking regulators, and other interested parties on the development and implementation of the Basel II standards for real estate lending. To ensure the safety and soundness of our financial institutions, MBA recommends that Basel II reflect the underlying risk of loans secured by single-family and commercial real estate through refined risk weights. Risk weights should also be refined for mortgage-backed securities, particularly for highly-rated issues and tranches. Regulators also should reward non-A-IRB lending institutions that utilize exemplary underwriting standards, practices and technologies.

Please do not hesitate to contact MBA if we may be of further assistance. Should you have any additional questions, please contact Leanne Tobias, Director, Commercial Real Estate Finance (tel: 202/557-2840; e-mail: [LTobias@mortgagebankers.org](mailto:LTobias@mortgagebankers.org)) on commercial and multifamily matters and Alison Utermohlen, Senior Director, Government Affairs (tel: 202/557-2864; [AUtermohlen@mortgagebankers.org](mailto:AUtermohlen@mortgagebankers.org)) on one-to four-family residential matters.

Most sincerely,



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