NATIONAL ASSOCIATION OF REALTORS®

The Voice For Real Estate®

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March 26, 2007

Office of the Comptroller
of the Currency
Mail Stop 1-5
250 E Street, SW
Washington, DC 20219
Docket No. 06-09
[Transmitted by e-mail:
regs.comments@occ.treas.gov]

Board of Governors of the Federal
Reserve System
Ms. Jennifer J. Johnson, Secretary
20th Street and Constitution Ave., NW
Washington, DC 20551
Docket No. R-1261
[Transmitted by e-mail:
regs.comments@federalreserve.gov]

Office of Thrift Supervision
Regulation Comments
Chief Counsel's Office
1700 G Street, NW
Washington, DC 20552
No. 2006-33
[Transmitted by e-mail:
regs.comments@ots.treas.gov]

Federal Deposit Insurance Corporation
Robert E. Feldman, Executive Secretary
Attn: Comments/Legal ESS
550 17th Street, NW
Washington, DC 20429
RIN 3064-AC73
[Transmitted by e-mail:
comments@fdic.gov]

Re: Risk-Based Capital Guidelines: Advanced Capital Adequacy Framework [Basel II]

Dear Sir or Madam:

On behalf of the more than 1.3 million members of the National Association of REALTORS® (NAR), I am pleased to provide comments to the federal banking agencies regarding the Joint Notice of Proposed Rulemaking (NPR) published on September 25, 2006. The federal banking agencies issued the NPR as part of the process of implementing the Basel II Capital Accord that was agreed to internationally in June 2004.

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EQUAL HOUSING OPPORTUNITY

The National Association of REALTORS®, "The Voice for Real Estate," is America's largest trade association, including NAR's five commercial real estate institutes and its societies and councils. REALTORS® are involved in all aspects of the residential and commercial real estate industries and belong to one or more of some 1,400 local associations or boards, and 54 state and territory associations of REALTORS®. Thus, to the extent that the proposed Basel II framework will have an impact on the availability of credit for residential or commercial real estate financing transactions, the proposal is of vital concern to NAR and its members.

The Basel II Capital Accord is intended to replace, for our largest and most sophisticated banking institutions that engage in complex financial transactions, the current risk-based capital system (Basel I), that was developed in the late 1980s, when modern techniques for calibrating capital and risk were in their infancy. As a result, the Basel I capital framework is not considered to accurately align regulatory capital for these large institutions, and thus can undermine supervisory objectives with respect to these companies.[1] The Basel II framework is designed to correct the deficiencies in the Basel I system through the use of measures that more accurately relate to risk and capital. The banking agencies are concurrently proposing improvements to Basel I under a new optional capital framework, called Basel I-A, for non-Basel II banks. NAR is submitting a separate comment letter on the Basel I-A NPR.

This notice of proposed rulemaking is intended to lead to final regulations necessary to implement the Basel II framework in the United States. NAR supports the concept of risk-based capital, and believes that adjusting capital to the economic risk of a depository institution's portfolio and off-balance sheet commitments will enhance the safety and soundness of our financial system, and will benefit the economy by reducing the inefficiencies caused by capital requirements that are excessive in light of risk.

Capital serves as a constraint on credit availability, and capital requirements in excess of the amount needed for safety and soundness unnecessarily reduce the availability of credit to our economy. On the other hand, capital also provides a buffer against failure, and capital requirements that are too low impair the safety of our financial system. One goal of a risk-based capital system is to strike the correct balance between bank safety and credit availability.

The NPR makes many improvements in our capital system for the country's largest banks. However, as discussed below, we believe that there are a number of modifications that could make the proposal more effective in reaching the important goal of balancing safety and credit availability.

[1] "The crude risk-weighting mechanisms of Basel I bear little resemblance to the complex risk profiles and risk management strategies that larger banks are capable of pursuing. The misspecification of risk under Basel I creates inappropriate incentives and arbitrage opportunities that can undermine supervisory objectives." Statement of Comptroller Dugan before the House Subcommittee on Financial Institutions and Consumer Credit (Sept. 14, 2006).

I. Need for Additional Options

The Basel II Accord, as agreed to internationally, includes several options, all of which would be a significant improvement of the current rules. The options include a Standardized Approach which relies primarily on the application of objective data, such as credit ratings, to establish capital risk weights. The Foundation Approach is more complex than the Standardized Approach. The Foundation Approach the banking organization uses complex statistical formulas for computing its capital, but relies considerably on data inputs provided by its regulator. The Advanced Approach is the most complex, and each covered banking organization must calculate such information as the probability of default, exposure at default, and expected loss given a default, for most components of their portfolio, based on an individual analysis of its own historical data.

Unlike the other countries implementing the Basel II framework, the NPR is only authorizing the use of the Advanced Approach, and only for the very largest banking organizations. NAR believes that that the limited implementation of the Basel II Accord should be expanded so that all options available to foreign banking organizations are also available to our institutions.

Providing additional flexibility for U.S. institutions will enable a larger number of U.S. banks and thrifts to utilize the more advanced capital standards, thus achieving a better correlation between capital and risk for the entire industry. The U.S. economy as a whole will benefit as regulatory capital requirements are rationalized with the risk of loans and other banking assets. Funding for safer loans will reflect lower capital requirements through lower cost or increased availability, or both. Authorizing for U.S. institutions the full range of options that European and other foreign banks may use under the Basel II Accord will provide substantial benefits for the U.S. economy while enhancing the safety and soundness of the banking industry by making capital more risk sensitive than under the Basel I rule.

II. Impact of the Leverage Ratio

In addition to the risk-based capital requirement, U.S. banks and thrifts are also subject to a separate “leverage ratio” capital standard. The leverage ratio requires a specified percentage of capital of all on-balance sheet assets, regardless of the risk of those assets. By statute, the leverage ratio cannot be less than 2 percent of assets for banks,[2] or 3 percent of assets for savings associations.[3] By regulation, however, a well capitalized institution must maintain a leverage ratio of at least 5 percent, and an adequately capitalized institution is generally required to have a leverage ratio of at least 4 percent.[4] So for example, a well capitalized bank will have to hold the

[2] 12 U.S.C. § 1831o(c).

[3] 12 U.S.C. § 1464(t)(2)(A).

[4] 12 CFR § 6.4(b)(1)(iii) and § 6.4(b)(2)(iii).

same $5 in capital for a short-term $100 U.S. Treasury note as for a $100 unsecured personal loan.

We believe that the leverage ratio serves as an important safeguard to assure some minimum capital requirement is in place as the industry transitions to the new Basel II regulations. However, as the Basel II framework is implemented domestically, the banking regulators should review the impact of the leverage ratio requirement on the risk-based system. The leverage ratio would do more harm than good if it has the effect of nullifying the benefits of the new risk-based framework, and should be adjusted as necessary to assure that this does not happen. We urge the agencies to pay particular attention to whether a minimum leverage ratio will place our largest financial institutions at a competitive disadvantage internationally, in light of the fact that the European Union does not impose a similar leverage requirement. Implementation of Basel II should not inadvertently promote transfer of capital abroad, enhanced penetration of U.S. markets by foreign banking institutions, or harm to the U.S. economy.

III. Mortgage Loans

The most significant advance made by the Basel II Accord is to better align capital with the statistically based risk of the bank's assets. Under the Advanced Approach, this is done through a determination, made individually by each covered banking organization, of key inputs for each segment of its assets. The results of this process enable covered institutions to compute such data as the probability of default, the bank's exposure at default, and the expected loss in the event of a default (both under a mix of conditions and under economic downturn conditions).

However, with respect to residential mortgage loans, the NPR deviates from the international Basel II Accord by imposing a 10 percent floor on the expected loss for loans predicted to default. In the case of prime mortgage loans, the probability of a default may be very low, but with respect to the small number of loans that are predicted to default, the bank cannot estimate its economic loss as less than 10 percent of its exposure at default, even if its historic data indicate that actual economic losses will be less.[5] This limitation is *not* found in the Accord, is *not* imposed on foreign banks, and is *not* consistent with the underlying principles of the new framework. NAR recommends that the agencies remove this unnecessary limitation in the final regulation.

NAR also notes that the proposal defines a residential mortgage exposure as a loan primarily secured by a first mortgage or subsequent line of credit on a 1- to 4-family residential property, or a loan that is secured by *other* residential property that has an original and outstanding balance of $1 million or less. NAR supports the inclusion of multifamily and other residential loans within the definition of residential mortgage exposure, but believes that the $1 million should be adjusted upward. At a minimum, the cap should equal the 1 million Euro cap found in the Basel II Accord that equates to approximately $1.31 million.

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[5] The 10 percent floor on expected loss does not apply if the mortgage is unconditionally guaranteed by a central government, or an agency, department, ministry, or central bank of a central government.

IV. Commercial Real Estate

Under the NPR, a banking organization authorized to use the Advanced Approach is required to distinguish commercial real estate into two categories. The first category is High Volatility Commercial Real Estate (HVCRE) which is defined as a credit exposure that finances the acquisition, development, or construction of real property. However, HVCRE does not include loans that are financing the acquisition, development, and construction of 1- to 4-family residential properties. In addition, HVCRE does not include loans financing the acquisition, development, and construction of certain commercial buildings if the developer has made a capital contribution of at least 15 percent and the value of the loan is very well secured. The second category is non-HVCRE loans, which are defined as all other commercial real estate exposures.

NAR believes that this is an appropriate approach, and in our letter on the Basel I-A proposed rule, urges that the agencies consider a similar approach there as well. In addition, NAR notes that the Basel II Accord recognizes another category of commercial real estate, Income-Producing Real Estate (IPRE). If the Basel II alternatives are made available to a broader segment of U.S. institutions, it would be important for the U.S. to also recognize this category for those institutions that are not computing their own probability of default for commercial real estate exposures.

On the other hand, NAR is concerned about the proposed exclusion of certain mortgage loans from the risk-based approach, based on what we believe is a misconstruction of statute. Under the Resolution Trust Corporation Refinancing, Restructuring, and Improvement Act of 1991,[6] the banking agencies were directed to assign certain pre-sold 1- to 4-family and multifamily construction loans to the 50 percent risk weight basket. The legislative history of this provision indicates that it was intended to lower the risk weight of these exposures to a level consistent with the Basel I capital accord.[7] In light of this legislative history, it would be an absurd result to single out these loans for a more punitive capital treatment that is being proposed for similar loans that are not precisely described in the legislation. Further, since the legislative history indicates that the 50 percent risk weight was selected in order to maintain consistency with the international (Basel I) capital requirements, it would be reasonable to interpret the statute as permitting the agencies to set a risk weight that is consistent with the new international standard, i.e., the Basel II framework.

V. Small Business Loans

The Basel II Accord establishes a special rule for loans to small- and medium-size business enterprises (SME). Under the Accord, exposures to business enterprises that have

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[6] Public Law 102-233, § 618 (1991).

[7] See statements of the authors of this provision, Congressman Wylie and Congresswoman Morella, at 137 Cong. Rec. H11842 (1991).

consolidated sales of less than 50 million Euros ($65.8 million) are given a preferential risk weight. The Accord also permits countries to use total consolidated assets as a basis for this beneficial treatment when total sales are not a meaningful indicator of size. The U.S. proposed rule provides no similar benefit for small business lending. Since this provision was agreed to by the U.S. regulators for foreign banks, we see no reason why similar treatment should not apply for U.S. institutions.

VI. Competitive Concerns

An overriding issue in the NPR is the fact that different capital standards for U.S. banking organizations could create competitive advantages for larger banks over the rest of the financial services industry domestically. Likewise, the development of a more stringent Basel II standard for large U.S. institutions, compared to the Basel II standard used abroad, has the potential to create competitive advantages on the international level for foreign institutions. As a result, there could be increased penetration by large foreign banks in U.S. markets. Competitive advantages that result from different capital standards could well lead to increased consolidation of the U.S. banking market, fewer community-based financial institutions, and the growth of and potential dominance by foreign banks.

It is critical for this result to be avoided. The Basel II Accord is currently being implemented abroad, and the U.S. agencies have an obligation to consider and mitigate to the extent possible the competitive benefits that such a framework conveys on foreign banks and on larger U.S. banks. To this end the agencies should offer U.S. banks the widest possible range of alternative capital standards consistent with the Accord and safe and sound banking. These options include the Foundation Approach and Standardized Approach specifically authorized by the Accord, as well as the Basel I-A alternative. Further, and in particular, the Basel I-A proposal should be modified to provide significantly more equality among banking organizations of all sizes.

Additional flexibility can also be provided by recognizing that many smaller banks are specialized lenders, concentrating in making loans such as residential mortgage, small business, and consumer loans. For example, if a smaller bank or thrift institution were permitted to opt-in to the Basel I-A or Standardized Approach for purposes of risk weighting its mortgage loans, but could remain on Basel I for its other assets, considerable benefit would accrue to both the bank, the banking system, and the economy. The bank would be able to more accurately risk weight the overwhelming majority of its assets, the banking system would have a higher percentage of assets subject to the more advanced capital standard, and the economy would benefit by having more capital available to support mortgage lending.

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

Sincerely yours,

David A. Lereah
Senior Vice President, Chief Economist