NAHB
NATIONAL ASSOCIATION
OF HOME BUILDERS

REGULATORY & HOUSING POLICY AREA

DAVID A. CROWE
Senior Staff Vice President

January 18, 2006

Mr. Robert E. Feldman
Executive Secretary
Federal Deposit Insurance Corporation
550 17th Street, NW
Washington, DC 20429
Attention: Comments/Legal ESS

Docket No. 05-16
Office of the Comptroller of the Currency
Public Information Room
250 E Street, SW
Mail Stop 1-5
Washington, DC 20219
Attention: RIN 1557-AC95

Docket No. R-1238
Ms. Jennifer J. Johnson
Secretary
Board of Governors of the Federal Reserve System
20th Street and Constitution Avenue, NW
Washington, DC 20551

Regulation Comments
Chief Counsel's Office
Office of Thrift Supervision
1700 G Street, NW
Washington, DC 20552
Attention: No. 2005-40.

Re: Risk-Based Capital Guidelines; Capital Adequacy Guidelines; Capital Maintenance: Domestic Capital Modifications
70 FR 202 (October 20, 2005)

On behalf of the 220,000 member firms of the National Association of Home Builders (NAHB), I welcome the opportunity to respond to the Advance Notice of Proposed Rulemaking (ANPR) issued jointly by the Office of the Comptroller of the Currency (OCC), the Board of

Governors of the Federal Reserve System (Board), the Federal Deposit Insurance Corporation (FDIC) and the Office of Thrift Supervision (OTS), collectively, the Agencies. The ANPR sets forth the Agencies' views on enhancing the risk sensitivity of the capital framework that applies to banks, bank holding companies, and savings associations.

NAHB is a national trade association representing individuals and companies involved in the production of housing and related activities. Each year, NAHB's builder members construct about 80 percent of all new housing in America. NAHB's builder members are small businesses with limited capital of their own. These small businesses depend almost entirely upon commercial banks and thrifts for credit. Our surveys show that 90 percent of all loans for residential construction, land acquisition and development come from commercial banks and thrifts. Consequently, the capital treatment of these types of loans is critical to the health of the home building industry.

Background

The current U.S. risk-based capital rules were adopted in 1989 and are based on the Basel Capital Accord, an internationally agreed upon framework for measuring and determining the capital requirements for financial institutions (Basel I). Since the implementation of the Basel I framework, the Agencies have made numerous revisions to their risk-based capital rules in response to changes in financial market practices and accounting standards. In more recent years, the Agencies have opted instead to work with the Basel Committee on Banking Supervision (Basel Committee) in developing a new version of the Basel Capital Accord. The new accord, so-called Basel II, would incorporate advances in risk measurement and management practices, and refine the procedures used to assess capital charges in relation to risk.

In August 2003, the Agencies issued an Advance Notice of Proposed Rulemaking (Basel II ANPR), which explained how the Agencies might implement the Basel II approach in the United States. In the Basel II ANPR, the Agencies proposed implementing only the most advanced approaches of the Basel II framework for the measurement of capital at the very largest, internationally active U.S. financial institutions.

Since the Basel II ANPR was issued, the Agencies also began considering whether to revise the current risk-based framework, which would continue to be applicable to the vast majority of U.S. financial institutions. The Agencies grew increasingly concerned that the implementation of Basel II would create a bifurcated regulatory capital framework in the United States, which may result in regulatory capital charges that differ for similar products offered by both large and small banking organizations. Accordingly, the Agencies issued the ANPR to seek comments on a number of conceptual revisions to the Basel I-based regulations. In considering revisions to the domestic risk-based capital rules the Agencies were guided by five broad principles. According to the Agencies, the revised framework must: (1) promote safe and sound banking practices and a prudent level of regulatory capital, (2) maintain a balance between risk sensitivity and operational feasibility, (3) avoid undue regulatory burden, (4) create appropriate incentives for banking organizations, and (5) mitigate material distortions in the amount of regulatory risk-based capital requirements for large and small institutions.

NAHB Position

NAHB endorses attempts by the Agencies to refine bank capital requirements so that a bank's capital level is a more precise and direct reflection of its risk profile. NAHB notes recent studies conducted by the Agencies demonstrating that capital requirements are a significant factor in a financial institution's transaction costs. In other words, capital requirements influence the extent to which a financial institution engages in a particular activity. Moreover, these studies demonstrate that comparatively lower capital costs provide a significant advantage to an institution vis a vis its competitors.

NAHB also recognizes that the ability to measure, scrutinize and manage risk has evolved dramatically. NAHB supports the Agencies' current initiative to revisit the current capital framework with an eye towards incorporating recent advances in risk management, oversight and supervision.

In comments submitted to the Agencies' Basel II ANPR, NAHB noted that while some aspects of Basel II may represent an improvement over current capital regulations, other aspects could unnecessarily impact the cost and availability of housing production loans from insured depository institutions. Regrettably, NAHB believes the Agencies' ANPR for changes to Basel I suffers from a similar flaw. The remainder of NAHB's comments focuses on these possible adverse consequences and offer recommendations to avoid such outcomes. Our comments also address Basel II's potential adverse impact on affordable housing and the competitive environment for smaller banking institutions.

Treatment of Residential Acquisition, Development and Construction Loans

NAHB is concerned that the Proposal perpetuates the Agencies' failure to make appropriate distinctions for the highly varied credit risk characteristics of the wide range of activities that the Agencies would consolidate under the CRE risk class. Moreover, NAHB believes that the Agencies have mischaracterized the risks associated with housing production, or residential land acquisition, development and construction (AD&C), lending activities.

Under the current regulations for U.S. financial institutions, most housing production loans require a capital backing of 8 percent. This is the standard requirement for most loans and investments on U.S. financial institution balance sheets. One notable exception is the capital treatment of construction loans on pre-sold single family homes, which currently have a 4 percent capital requirement, giving these loans the same preferred capital standing as most home mortgages. In the Basel I ANPR, the Agencies seek comment on a very different capital framework for such loans.

In the Basel I ANPR, the Agencies propose to include "some types" of AD&C loans in a category called "Commercial Real Estate Exposures (CRE)." The ANPR does not elaborate on the types of AD&C loans that will fall into the CRE category. However, loans in the CRE category would receive a higher capital charge than the current 8 percent. The Agencies state that the higher capital requirement is a result of "longstanding supervisory experience with certain CRE exposures."

NAHB urges the Agencies to reevaluate their assumptions about the risks associated with residential AD&C lending activities. In doing so, it is likely that the Agencies will discover that residential AD&C loans do not belong in the CRE category because of their relatively low risk.

Without appropriate distinctions for the highly varied credit risk characteristics of the wide range of assets in bank portfolios, the approach proposed in the Basel I ANPR would raise the amount of capital that financial institutions must hold for many residential AD&C loans above current requirements, resulting in an inappropriate calibration of capital to risk on a bank's balance sheet. This treatment could discourage banks from engaging in residential AD&C lending activities because such lending carries the same capital expense as other riskier lending activities. Alternatively, these institutions could decide to increase the interest rate and/or fees charged on residential AD&C loans to compensate for the higher capital requirements. This would result in a significant step backward from the current system, where single family construction loans on pre-sold homes receive the same preferable capital treatment accorded home mortgages, 4 percent, while other residential production loans receive the standard 8 percent capital treatment.

NAHB also questions the Agencies' proposal to combine the Interagency Real Estate Lending Standards with a requirement to have substantial borrower equity as criteria for an exemption from the high risk-weight treatment. NAHB is a strong supporter of the Interagency Real Estate Lending Standards and was, in fact, an active participant in their establishment. We therefore believe that they are an appropriate criterion for providing an exemption from the ANPR's high risk-weight for CRE loans. However, because these standards are based in large measure on loan-to-value ratios, combining this criterion with the substantial borrower equity criterion for high risk weight exemption purposes is redundant, if not inconsistent. NAHB therefore requests that the Agencies eliminate the substantial borrower equity requirement for the exemption from the CRE's high risk weight. NAHB believes this would reduce the regulatory complexity of the ANPR while maintaining its strong safety and soundness features.

NAHB Risk Analysis of Residential AD&C Loans

NAHB's analysis of time-series data from the OTS Thrift Financial Report shows that the charge-off rates for residential housing production loans are dramatically lower than for nonresidential real estate loans. In fact, the performance of single family home construction loans has been very close to the experience for home mortgages. We have attached a series of charts and a table with the underlying data that demonstrate the performance of residential AD&C loans compared to other asset categories.

NAHB's analysis comports with the findings in a white paper published by the Board describing the Board's analysis of the loss characteristics of commercial real estate loan portfolios of U.S. financial institutions. The white paper notes that some key features of single family construction loans (i.e., high proportion of pre-sales and substantial borrower equity) could be positive factors resulting in lower capital requirements for such loans. Further, the Board's analysis suggests that the asset correlation for single-family construction loans may be smaller than the asset correlation for other construction loans. Accordingly, the white paper states "… the available evidence suggests that perhaps these loans should be classified as having low rather than high asset correlation."

The Board's white paper also indicates that the short maturity of a loan is another risk mitigating factor that would justify a low volatility risk weight for residential AD&C loans. NAHB notes that the vast majority of residential AD&C loans have maturities that fall well below the 2.5 years cited in the white paper as a benchmark for incurring a low-volatility risk weight.

Given the empirical evidence presented in both NAHB's and the Board's analyses, NAHB believes that all residential AD&C loans should be classified in a lower risk weight category than other CRE loans.

Competitive Impact of the ANPR

NAHB supports the Agencies' proposal in the ANPR to expand the risk weight continuum for residential mortgages. We believe this approach ameliorates some of the identified competitive inequities that would result from implementing Basel II in the U.S. However, NAHB does not have the same level of confidence with respect to the Agencies' proposed approach to CRE loans. NAHB's apprehension is attributable to the fact that Basel II is significantly more complex and comprehensive than the approach proposed in the Basel I ANPR and will likely result in significant disparity between the two capital standards. NAHB urges the Agencies to carefully evaluate whether Basel II's complexities provide exploitable opportunities that do not exist in the ANPR.

Conclusion

NAHB endorses the Agencies' conceptual approach to establish greater risk-sensitive detail for financial institutions that do not adopt Basel II. As a reflection of the superior loss performance of housing production loans, NAHB urges the Agencies to classify all residential AD&C loans into a lower risk weight category than other CRE loans.

NAHB stands ready to work with the Agencies to explore the various options that may be available to revise the capital framework for financial institutions in a manner that does not create competitive inequities.

Thank you for your consideration and we invite you to call on us if we can provide additional information.

Sincerely,

David Crowe

David A. Crowe, Ph. D.
Senior Staff Vice President
Regulatory and Housing Policy

Attachment

Acquisition, Development and Construction (AD&C) Loan Performance Data 1990 through 2004

Compiled by:
Housing Finance Department
National Association of Home Builders

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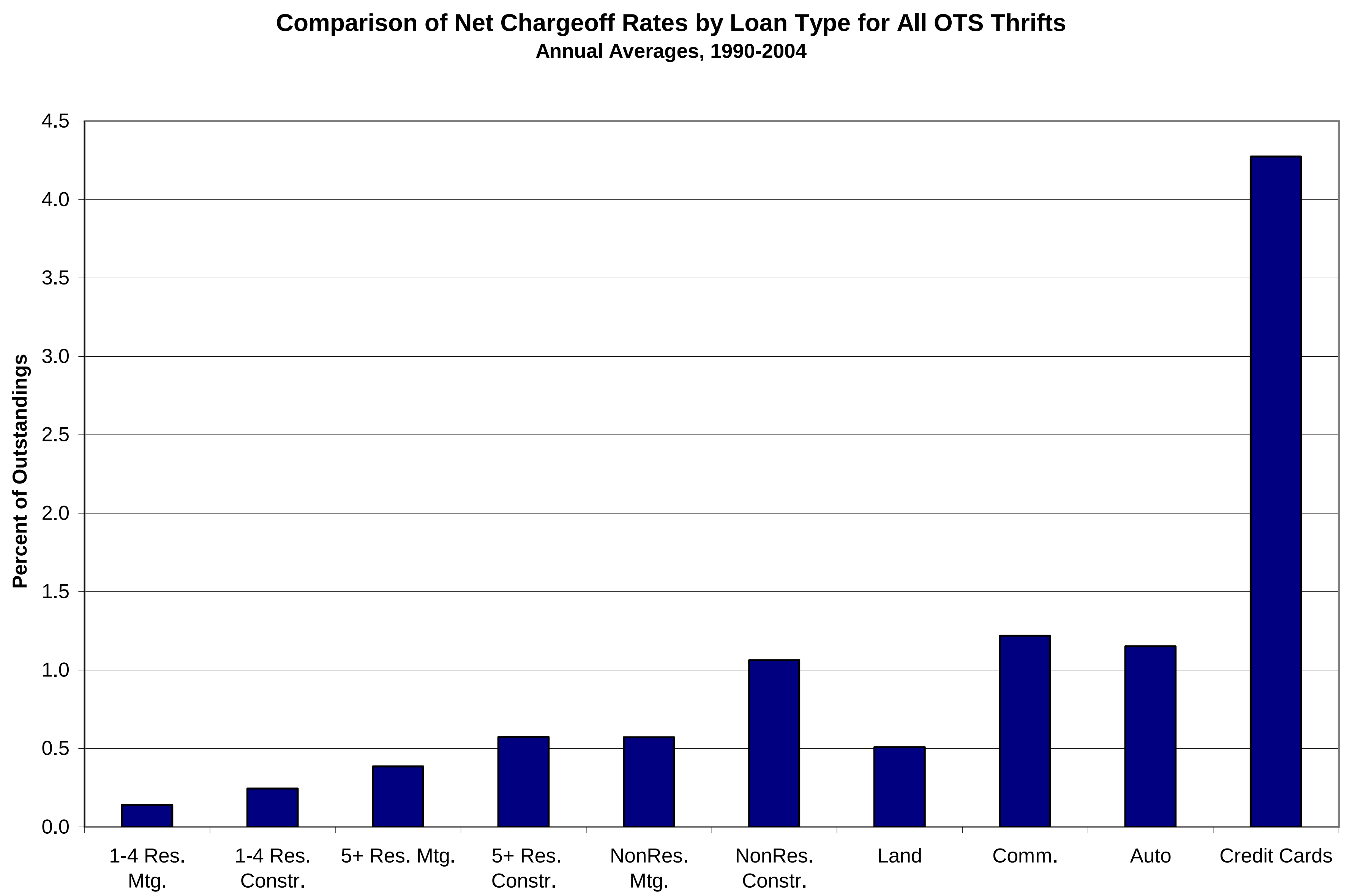
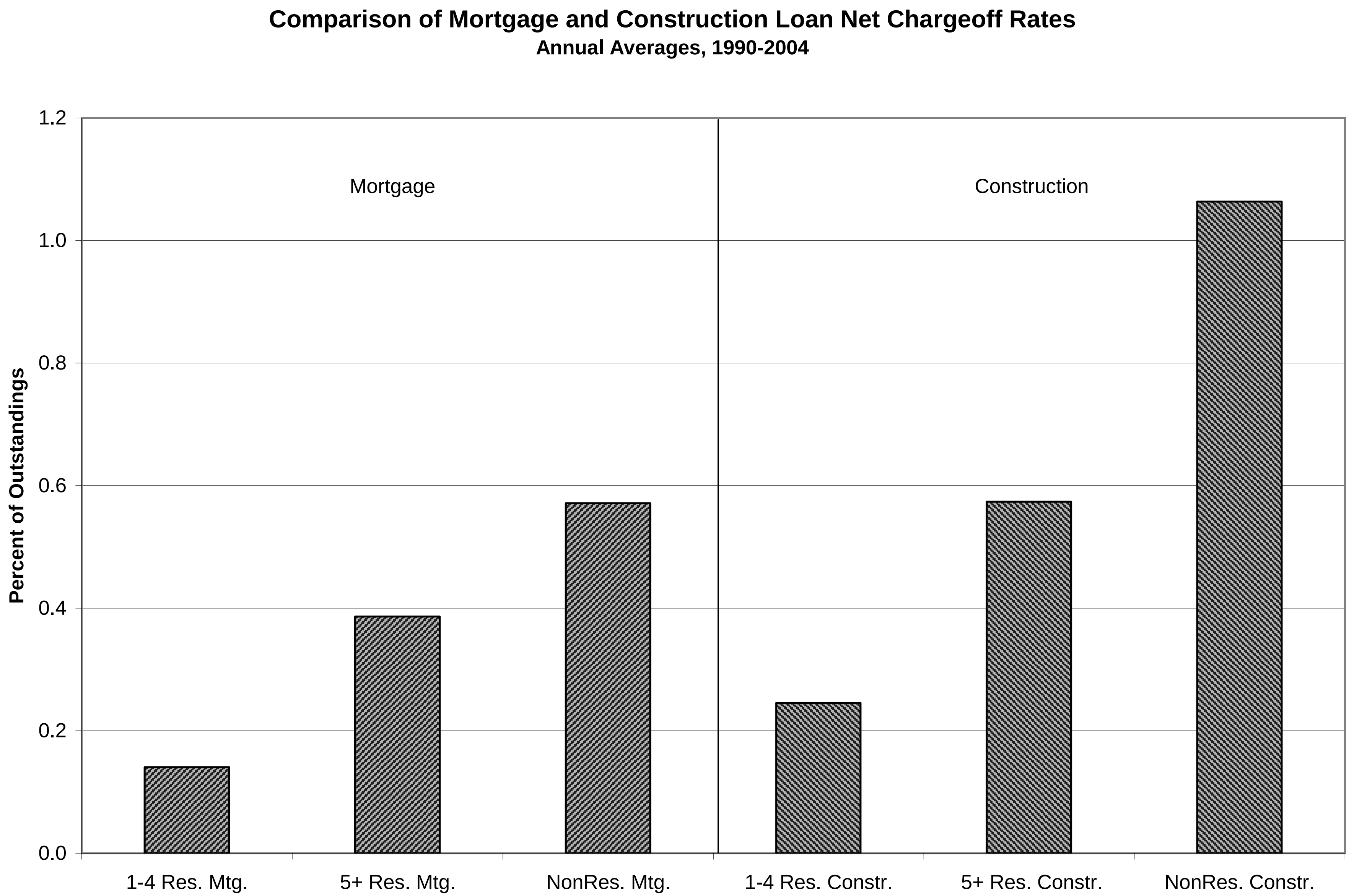
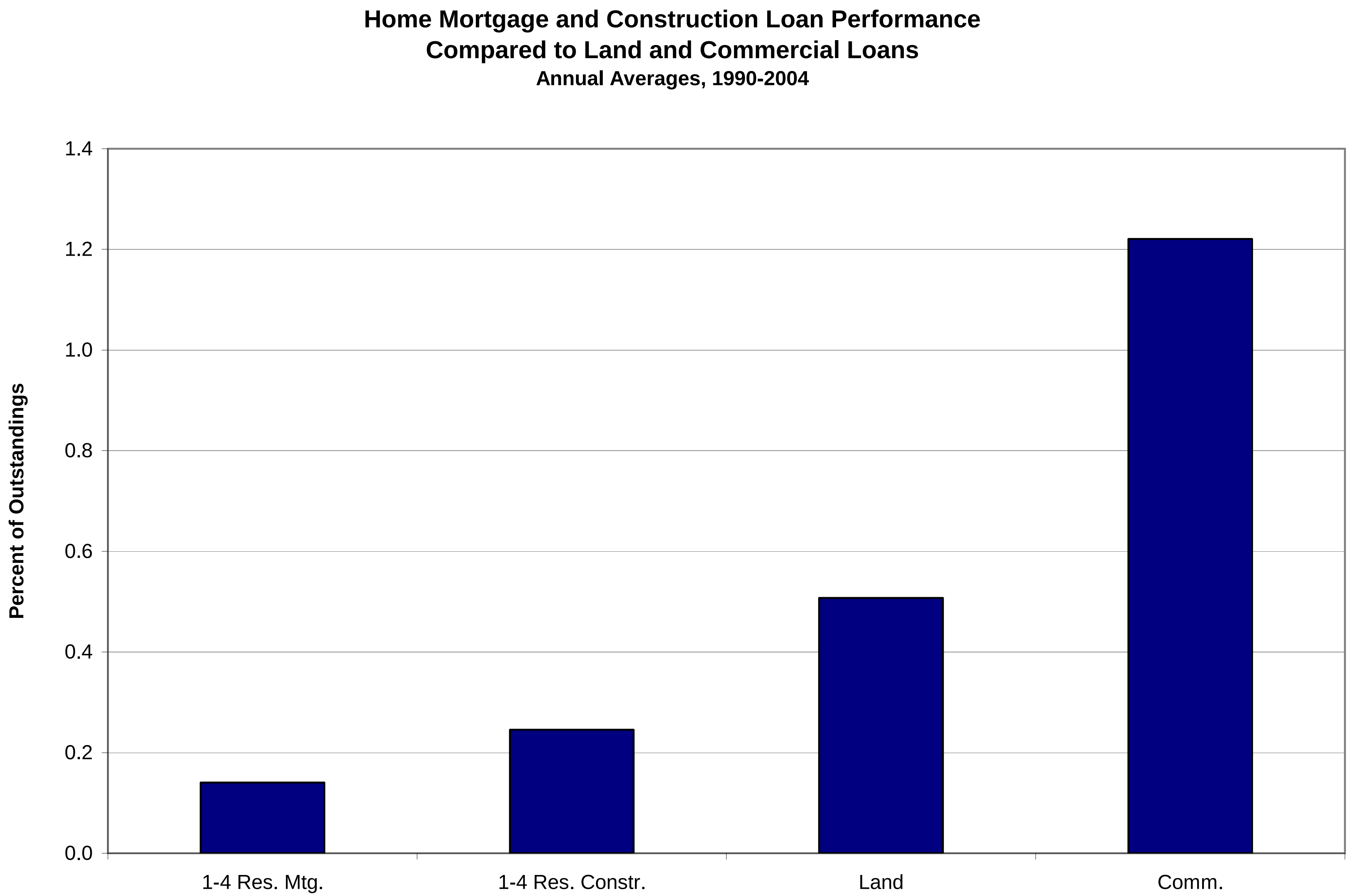
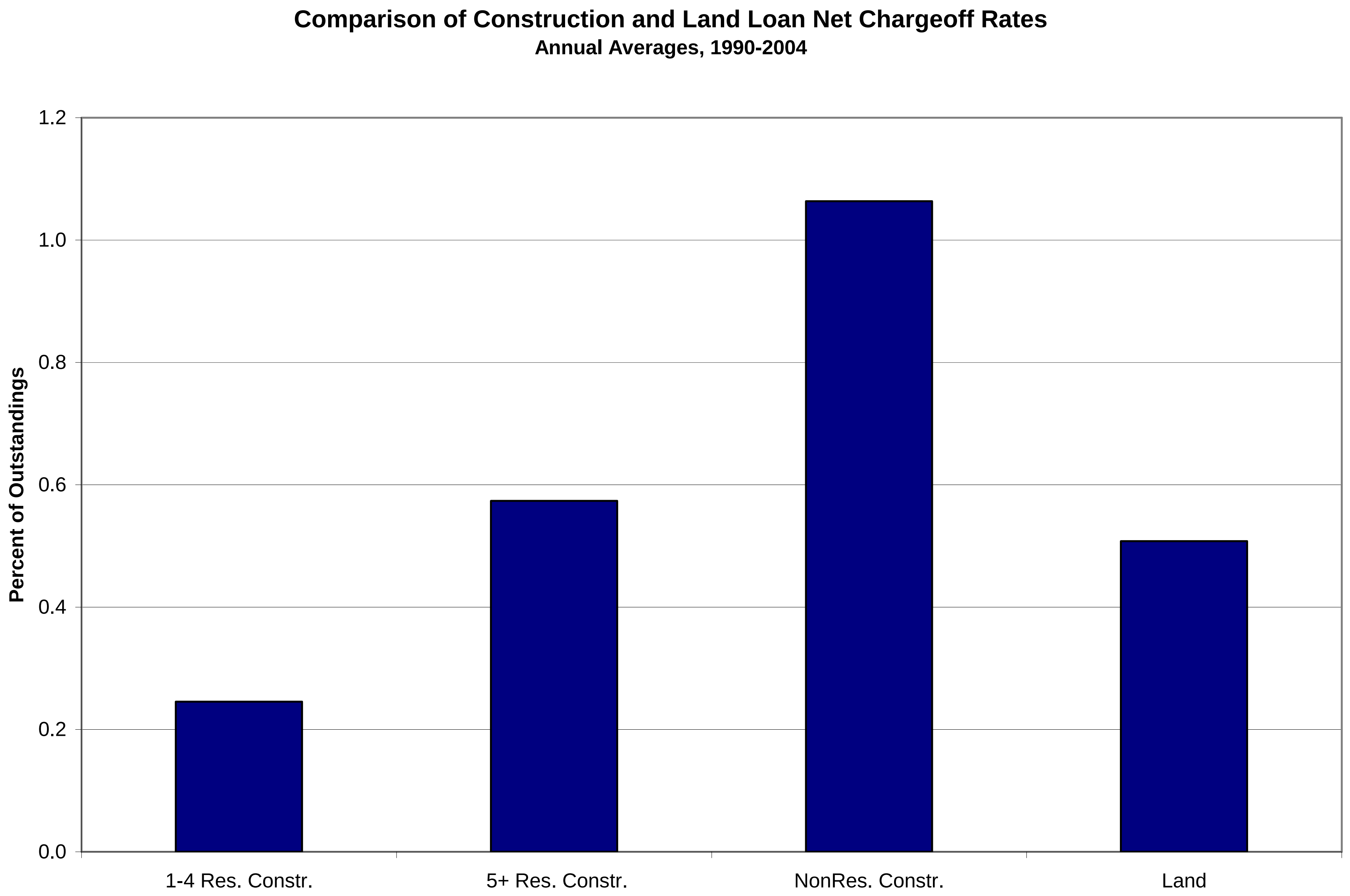
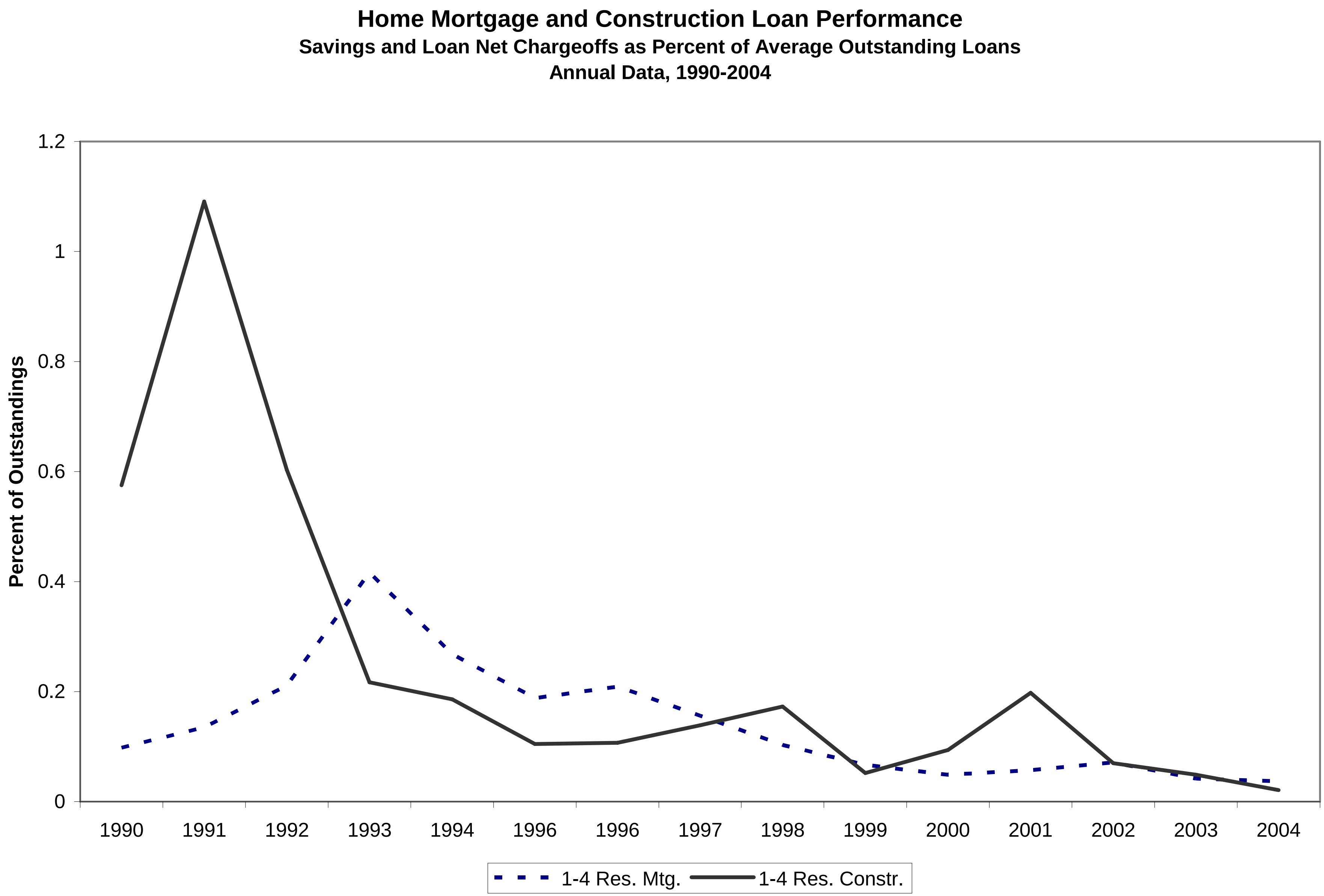

Comparison of Net Chargeoff Rates by Loan Type for All OTS Thrifts
Annual Averages, 1990-2004
Percent of Outstandings
4.5
4.0
3.5
3.0
2.5
2.0
1.5
1.0
0.5
0.0
1-4 Res. Mtg.
1-4 Res. Constr.
5+ Res. Mtg.
5+ Res. Constr.
NonRes. Mtg.
NonRes. Constr.
Land
Comm.
Auto
Credit Cards

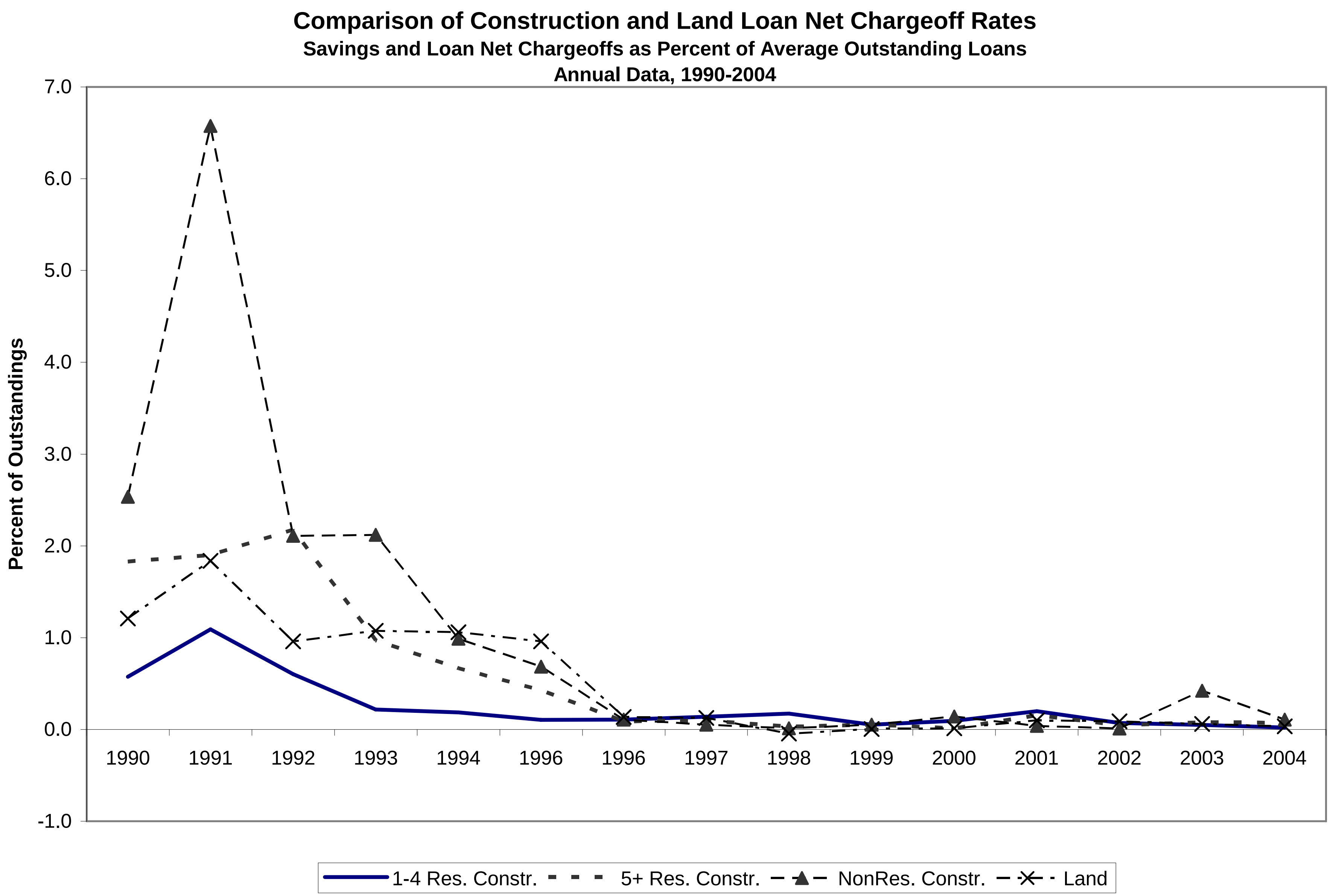

Comparison of Mortgage and Construction Loan Net Chargeoff Rates
Annual Averages, 1990-2004
Percent of Outstandings
1.2
1.0
0.8
0.6
0.4
0.2
0.0
Mortgage
Construction
1-4 Res. Mtg.
5+ Res. Mtg.
NonRes. Mtg.
1-4 Res. Constr.
5+ Res. Constr.
NonRes. Constr.

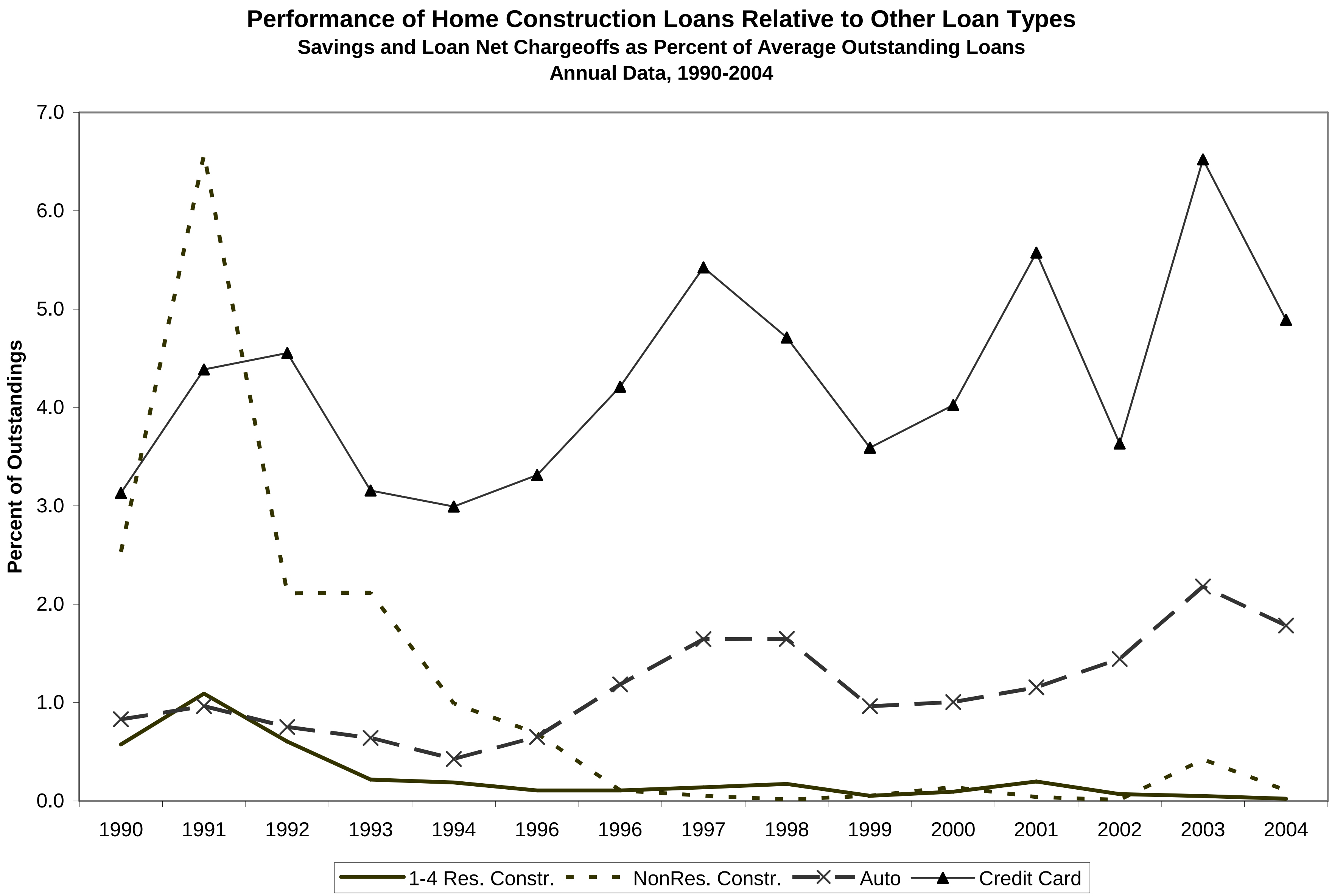

Home Mortgage and Construction Loan Performance
Compared to Land and Commercial Loans
Annual Averages, 1990-2004
Percent of Outstandings
1.4
1.2
1.0
0.8
0.6
0.4
0.2
0.0
1-4 Res. Mtg.
1-4 Res. Constr.
Land
Comm.



Comparison of Construction and Land Loan Net Chargeoff Rates
Annual Averages, 1990-2004
Percent of Outstandings
1.2
1.0
0.8
0.6
0.4
0.2
0.0
1-4 Res. Constr.
5+ Res. Constr.
NonRes. Constr.
Land


Home Mortgage and Construction Loan Performance
Savings and Loan Net Chargeoffs as Percent of Average Outstanding Loans
Annual Data, 1990-2004
Percent of Outstandings
1.2
1
0.8
0.6
0.4
0.2
0
1990
1991
1992
1993
1994
1996
1996
1997
1998
1999
2000
2001
2002
2003
2004
1-4 Res. Mtg.
1-4 Res. Constr.


Comparison of Construction and Land Loan Net Chargeoff Rates
Savings and Loan Net Chargeoffs as Percent of Average Outstanding Loans
Annual Data, 1990-2004
Percent of Outstandings
7.0
6.0
5.0
4.0
3.0
2.0
1.0
0.0
-1.0
1990
1991
1992
1993
1994
1996
1996
1997
1998
1999
2000
2001
2002
2003
2004
1-4 Res. Constr.
5+ Res. Constr.
NonRes. Constr.
Land



Performance of Home Construction Loans Relative to Other Loan Types
Savings and Loan Net Chargeoffs as Percent of Average Outstanding Loans
Annual Data, 1990-2004
Percent of Outstandings
7.0
6.0
5.0
4.0
3.0
2.0
1.0
0.0
1990
1991
1992
1993
1994
1996
1996
1997
1998
1999
2000
2001
2002
2003
2004
1-4 Res. Constr.
NonRes. Constr.
Auto
Credit Card

Net Charge-offs as Percent of Average Loan Amount - By Loan Type for all OTS Thrifts

Annualized from Quarterly Data

Year	Percent of 1-4 Res. Mtg. Loans	Percent of 1-4 Res. Constr. Loans	Percent of 5+ Res. Mtg. Loans	Percent of 5+ Res. Constr. Loans	Percent of Non-Res. Mtg. Loans	Percent of Non-Res. Constr. Loans	Percent of Land Loans	Percent of Comm. Loans	Percent of Auto Loans	Percent of Credit Card Loans
1990	0.098	0.575	0.835	1.829	1.389	2.533	1.208	1.310	0.829	3.131
1991	0.135	1.091	0.610	1.898	1.166	6.574	1.836	2.190	0.963	4.386
1992	0.211	0.603	0.724	2.176	1.321	2.110	0.960	1.455	0.751	4.554
1993	0.416	0.217	0.844	0.971	1.629	2.119	1.076	3.067	0.641	3.154
1994	0.268	0.186	1.446	0.667	1.168	0.989	1.059	0.902	0.426	2.993
1996	0.188	0.105	0.644	0.427	0.781	0.684	0.959	0.674	0.651	3.312
1996	0.209	0.107	0.524	0.088	0.392	0.106	0.135	0.314	1.185	4.212
1997	0.156	0.139	0.183	0.098	0.084	0.052	0.126	0.382	1.646	5.424
1998	0.103	0.173	0.068	0.032	0.087	0.014	-0.045	0.447	1.648	4.711
1999	0.067	0.052	-0.069	0.053	0.042	0.052	0.006	0.473	0.964	3.592
2000	0.049	0.094	-0.033	0.013	0.040	0.141	0.012	0.946	1.004	4.024
2001	0.057	0.198	0.001	0.155	0.188	0.040	0.100	1.348	1.155	5.575
2002	0.071	0.07	-0.002	0.046	0.086	0.011	0.088	2.137	1.443	3.632
2003	0.042	0.049	0.007	0.079	0.082	0.421	0.061	1.175	2.181	6.523
2004	0.037	0.021	0.013	0.074	0.115	0.106	0.035	1.490	1.783	4.891
Average	0.140	0.245	0.386	0.574	0.571	1.063	0.508	1.221	1.151	4.274