NATIONAL ASSOCIATION
OF REALTORS®

*The Voice for Real Estate®*

430 North Michigan Avenue
Chicago, Illinois 60611-4087
312.329.8411 Fax 312.329.5962
Visit us at *www.REALTOR.org.*

NRT, Inc.
465 Maple Avenue West, Suite B
Vienna, Virginia 22180-3441
703/268-2001 Fax 703/356-3441
E0mail: tstevens@cbmove.com

**Thomas M. Stevens, CRB, CRS, GRI**
*President*

January 18, 2006

Communications Division
Public Information Room, Mail Stop 1-5
Office of the Comptroller of the Currency
250 E Street, SW
Washington, DC 20219
Attn: Docket number 05-16

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

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

Mr. Robert E. Feldman, Executive Secretary
Federal Deposit Insurance Corp.
550 17th Street, NW
Washington, DC 20429
Attn: Comments/Legal ESS
RIN 3064-AC96

Comment Re: Risk-Based Capital Guidelines; Capital Adequacy Guidelines; Capital Maintenance; Domestic Capital Modifications

Dear Sir or Madam:

On behalf of the more than 1.2 million members of the National Association of REALTORS® (NAR), I am pleased to provide comments to the Federal banking agencies regarding the joint Advanced Notice of Proposed Rulemaking (ANPR) published on October 20, 2005.[1] The joint ANPR was issued by the Federal banking agencies in order to develop a revised Basel I capital framework (Basel I-A) for those depository institutions that will not be subject to the new Basel II standards.

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 1,700 local associations or boards , and 54 state and territory associations of REALTORS®. Thus, to the extent that the proposed Basel I-A 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 us and to our members.

Under current regulations, banking and thrift institutions (banking organizations) are subject to a risk based capital standard that is based on an international understanding reached by

1 70 Federal Register 61068 (October 20, 2005).

the banking regulators and central bankers of the leading economically developed countries in Basel, Switzerland, in 1988. This accord is commonly referred to as the Basel I capital framework, and it was implemented in this country beginning in 1989. Under the framework, the assets of banking organizations are assigned various "risk weights" based upon the relative credit risk of the asset, as determined by the regulatory agencies. Under the current standard, prudently underwritten mortgage loans are assigned to the 50 percent risk weight basket, and commercial real estate loans are assigned to the 100 percent risk weight basket.

More recently, the international and U.S. banking regulators and central bankers determined that the Basel I framework is in need of improvement. They believe that the current system does not accurately reflect the true economic risk of the various credits booked by banking organizations. Thus a mismatch exists between the true economic risk and the capital requirement imposed by the banking agencies. Further, the existing standard does not recognize many of the techniques a banking organization may use to mitigate risk, and therefore does not provide an incentive to take these measures.[2]

In recognition of these and other shortcomings, the international regulators developed a new capital framework, referred to as Basel II that will more closely align capital and risk. However, in the U.S. only a relatively small handful of the largest banking organizations will be subject to this new framework due to the complexity of the standard and the need for each institution to utilize costly and very sophisticated information management systems to comply with the requirements of the new framework.[3]

As a result, concerns have been raised that the banks subject to the new capital framework may gain a competitive advantage with respect to institutions subject the Basel I standards.[4] This concern is especially relevant in the area of home mortgage lending, where the capital requirement is predicted to be dramatically less for Basel II institutions.[5] As explained by one prominent banking trade association, the lower capital will most likely result in a cost advantage, and correspondingly a pricing advantage, in retail credits for Basel II banks. If community and other non-Basel II banks and thrift institutions are subjected to unfair competition from the largest banks, their ability to provide financial services to their communities and to compete effectively against large banks will

---

[2] See, e.g., FDIC Staff Study, "Basel and the Evolution of Capital Regulation" (January 14, 2003).

[3] Joint Federal Banking Agency Press Release, "Agencies Announce Publication of Revised Capital Framework and Describe U.S. Implementation Efforts" (June 26, 2004).

[4] See, e.g., Statement of Acting Comptroller Julie Williams, Before the Subcommittee on Financial Institutions and Consumer Credit of the House Committee on Financial Services (May 11,2005): "(T)he OCC and the other agencies have focused considerable effort and attention on the potential competitive effects of the Basel II framework on the U.S. financial services industry.... (W)e are concerned that Basel II may create or exacerbate relative advantages between large domestic banks and mid-size/small domestic banks...(I)t is imperative that the U.S. agencies remain sensitive to these concerns...."

[5] Based on a survey of banking organizations subject to Basel II, the capital requirements for residential mortgage loans will decline, on average, 62 percent, and the capital requirement for home equity lines of credit will decline, on average, by 74 percent, from the capital required for non-Basel II institutions. See, Statement of Richard Riccobono, Acting Director, Office of Thrift Supervision, before the Subcommittee on Financial Institutions and Consumer Credit of the House Committee on Financial Services (May 11, 2005).

suffer. The inevitable result will be further consolidation within the banking industry, resulting in an undesirable loss of locally focused institutions.[6] These smaller institutions are locally owned and run, and have expertise and detailed knowledge about their towns and communities that is not possible for larger national and regional organizations. The loss of these smaller institutions would result in an incalculable loss to the economy and vitality of our nation's financial system and the small business community nationwide.

Similarly, it is also important that, within the Basel I-A universe of depository institutions, the capital requirements be based on the relative risk of various activities so, for example, a thrift that makes real estate lending the primary focus of its business plan is not unfairly disadvantaged compared to larger lenders with other business plans.

The ANPR issued by the Federal banking agencies on October 20, 2005, is the agencies' attempt to deal with these concerns by making adjustments in the Basel I standard so that it is more risk sensitive, but without the regulatory burdens that will be required under Basel II. In so doing, the ANPR also seeks to address the competitive issues that are of great concern to the NAR, by mitigating some of the disparity in capital requirements between Basel II and non-Basel II institutions.

In this regard, the ANPR makes a number of very positive suggestions that will help alleviate many of the concerns we have about the Basel II standards. We appreciate the agencies' concerns in this regard, and believe that the Basel I-A proposal is a positive step. However, we also believe that there is room for some improvement. We are therefore offering the following suggested changes with respect to the treatment of both residential and commercial real estate loans and lines of credit.

1. <u>One- to Four-Family Mortgages</u>

Under current regulations, most one- to four-family first mortgages are eligible for a 50 percent risk weight. The ANPR states that this "one size fits all" approach does not adequately assess the credit risks posed by such loans. Instead, the ANPR proposes to assign a risk-weight to first lien one- to four-family mortgage loans after taking into account other factors, such as the loan-to-value (LTV) ratio of the loan, the credit-worthiness of the borrower (determined by a credit rating such as a FICO score), debt-to-income ratio, or some other measure of credit quality. These mortgages would then be assigned to a risk weight basket of between 20 and 100 percent.

More specifically, the joint ANPR proposes that first lien one- to four-family mortgage liens with an LTV ratio of 70 percent or less be placed in the 20 percent risk weight basket, and mortgage loans with an LTV above 70 percent and up to 80 percent be placed in the 35 percent risk weight basket. We believe that, in light of the very low credit risk posed by first lien residential mortgage loans, the risk weights suggested in the joint ANPR are too high. Similarly, in light of the favorable capital charge that would be imposed on these loans under Basel II, the weight baskets suggested in

---

[6] Statement of the Independent Community Bankers of America, before the Subcommittee on Financial Institutions and Consumer Credit of the House Committee on Financial Services (May 11, 2005). This concern was also raised by the trade association representing savings associations. <u>See</u>, Statement of America's Community Bankers, before the Subcommittee on Financial Institutions and Consumer Credit of the House Committee on Financial Services (May 11,2005).

the joint ANPR would not adequately deal with the competitive advantages Basel II provides to larger mortgage lenders.

There is no question that prudently underwritten first lien residential mortgage loans have historically low loss rates. According to Federal Reserve Board data, the average charge-off rate for these loans from 1991 through the third quarter of 2005 was 0.15 percent.[7] As a result, the Tier 1 capital charge for these loans under Basel II is predicted to be as low as 12 basis points for well-qualified borrowers.[8] Under the joint ANPR, this same loan would result in a Tier 1 capital charge of 80 basis points, assuming the loan qualifies for the 20 percent basket as proposed in the joint ANPR.

Under Basel II, if the same well-qualified borrower took out an 80 percent LTV mortgage loan, the Tier 1 capital charge would be 29 basis points. But under the joint ANPR, the capital charge for the non-Basel II bank would be 140 basis points, assuming the loan qualifies for the 35 percent basket as proposed in the joint ANPR.

Thus, the reduction in capital suggested in the joint ANPR would still leave a wide gap in the treatment of mortgage loans with equivalent risks. This large difference will create competitive inequalities between mortgage lenders and could easily lead to further consolidation in the mortgage lending industry. We therefore recommend a risk-weight basket of 10 percent for prime first lien residential mortgage loans with a 70 percent or lower LTV, and a risk-weight basket of 20 percent for prime mortgage loans with a LTV above 70 percent and up to 80 percent.[9] Finally, we recommend that corresponding changes should also be made to the risk baskets for residential mortgage loans with LTVs in excess of 80 percent to more accurately reflect the risk of these loans. These adjusted baskets would make the Basel I-A approach more risk sensitive and would reduce (but not eliminate) the competitive disparity between the two systems.

2. <u>Private Mortgage Insurance</u>

The joint ANPR states "(B)anking organizations would determine the LTV of a mortgage loan after consideration of the loan-level private mortgage insurance (PMI) provided by an insured with an NRSRO[10]-issued long-term debt credit rating of single A or higher." We agree that PMI provides valuable credit risk mitigation and should be recognized under the capital standards. However, we disagree that PMI should not be considered when issued on a portfolio basis. Rather, we believe that PMI provides credit protection whether written on an individual loan basis or on a portfolio basis, and urge that the new capital standards recognize the benefits provided by both pool and individual loan insurance coverage.

---

[7] Board of Governors of the Federal Reserve System, Charge-Off and Delinquency Rates, Not Seasonally Adjusted (Dec. 2005).

[8] Calem and Follain, "Proposed Competitive Impacts of Basel II in the U.S. market for Residential Mortgages," at page 35, statement before the House Subcommittee on Financial Institutions and Consumer Credit (May 11, 2005). According to this study, under Basel II, the capital charge for a first lien mortgage loan to a borrower with a FICO credit score 740 and with an LTV of 70 percent could be as low as 12 basis points.

[9] These baskets would result in a Tier 1 capital charge of 40 basis points and 80 basis points, respectively.

[10] Nationally Recognized Statistical Rating Organization (NRSRO).

We also disagree with the position that no capital credit should be given if the PMI contains a deductible under which the lender is required to absorb a first loss. PMI mitigates credit risk even if the lender is required to absorb a first loss, provided that the banking organization is willing to hold dollar for dollar capital against the amount of its potential first loss liabilities. If so, the banking organization should be permitted to treat the PMI as if it has no deductible. This modification would be especially important when considering a large portfolio of mortgage loans and the PMI deductible is relatively small.

3. Non-Traditional Mortgage Products

The ANPR notes that the Federal banking agencies are reviewing non-traditional mortgages, such as loans that permit negative amortization and loans that have an LTV in excess of 100 percent. The ANPR asks if these products should be dealt with in the general mortgage matrix, or if they warrant a higher capital treatment.

These loans can raise significant safety and soundness concerns if not properly underwritten. NAR is concerned that many borrowers do not understand the risk that come with these mortgages and is urging REALTORS® to help educate consumers about both the risks and rewards of nontraditional mortgages. However, when properly underwritten by the lender and fully understood by the borrower, non-traditional loans are often an appropriate product that provides useful alternatives for both high, middle, and lower income families, especially in high-cost areas. For example, for a high income mortgagor, a low or zero down payment loan can be a useful method to provide funds for other investments at a relatively low cost to the borrower. For a middle income borrower, non-traditional mortgage products may be used to provide a low cost source of funds for retirement plans or to provide for college savings. For many families, especially lower income families and families in high-cost areas, non-traditional loans increase the affordability of home ownership and provide a responsible method for people early in their careers to purchase a home without a large down payment.

As noted, non-traditional mortgage loans can create safety and soundness concerns when not properly underwritten. However, this is true for any type of loan that does not meet prudent underwriting standards. The failure of a banking organization to properly underwrite an extension of credit should be dealt with through the normal supervisory and examination process, and not through a capital charge that will unnecessarily penalize both banking organizations and consumers. In this regard we note that the Federal banking agencies recently published proposed guidance relating to non-traditional mortgage loans. We believe that both the guidance and any special capital rules must take a balanced approach so carefully underwritten and fully understood nontraditional mortgages remain available for borrowers to achieve homeownership, consistent with safety, soundness, and consumer protection.

4. Second Liens and Credit Lines

The joint ANPR proposes increasing the risk weight for second mortgage liens and home equity lines of credit if the combined LTV ratio of the first lien and second lien or line of credit exceeds 90 percent. The joint ANPR suggests that the risk weight for such loans could exceed 100 percent.

The risk weights for an unsecured retail loan or line of credit is 100 percent. The Basel II Accord states: "No transaction in which CRM (credit risk mitigation) techniques are used should receive a higher capital requirement than an otherwise identical transaction where such techniques are not used."[11] Credit risk mitigation techniques include collateralization requirements.[12] This principle should apply equally to both Basel II institutions and Basel I-A institutions. It simply makes no sense to penalize a bank for taking collateral when the institution could make a similar loan without collateral. We believe that to the extent that some second loans or lines of credit raise supervisory concerns, these concerns should be dealt with through the normal supervisory process and not through the capital standards.

5. Multifamily Residential Mortgages

The joint ANPR notes that except for certain specially qualified multifamily residential loans, these loans are generally assigned a risk weight of 100 percent. The ANPR asks whether these loans, or a subset of these loans, should be placed in a lower risk weight basket.

The NAR believes that multifamily residences with a history of high occupancy and revenue generation are much less risky than other, more speculative multifamily loans, and that the risk weight for these loans should be lowered in order to more accurately reflect the risk of these assets.

This would be consistent with the Internal Risk Based approach authorized under Basel II. Under this approach, which would be available for large U.S. banking organizations, loans secured by multifamily residential real estate in which the funds for repayment are generated by rental income are treated as income producing real estate (IPRE). This group of assets is generally afforded a lower risk weight than loans secured by other types of commercial real estate.[13] Likewise, we believe that a loan secured by a multifamily residential project with a high occupancy rate and history of revenue generation should also be treated more favorably.

6. Commercial Real Estate (CRE)

The Basel I framework assigns commercial real estate loans to the 100 percent risk weight basket. The joint ANPR proposes to move these loans to a higher than 100 percent risk-weight basket, unless the loan satisfies the prudential real estate lending guidelines and the loan is supported by a substantial equity investment by the borrower, such as 15 percent of the completion value.

---

[11] Basel II Accord par. 113.

[12] Basel II Accord par. 119.

[13] Under the Basel II internal risk based approach commercial real estate is divided into two categories: income-producing real estate (IPRE) and high-volatility commercial real estate (HVCR).[13] IPRE is characterized by the fact that the repayment of the loan is based on cash flows generated by the real estate, such as rent payments. HVRE is characterized by loans secured by real estate in which repayment is based on the future sale of the property, such as loans for the acquisition, development and construction of a new housing development. IPRE loans are generally given a lower risk weight than HVCR loans with similar probabilities of default. For example, a "strong" IPRE loan (with a low probability of default) is assigned a risk weight of 70 percent, but a HVCR loan with a similar probability of default is assigned a risk weight of 90 percent.

We acknowledge that commercial real estate lending contributed to many of the banking problems in the late 1980s and early 1990s. However, since that era, many of the practices associated with commercial real estate lending have been modified, and this sector has demonstrated a very impressive history of safety and soundness. Statistics complied by the Federal Reserve Board indicate that for the past 10 years the average charge-off rate for commercial real estate loans is only 0.10 percent.

According to the FDIC, the dynamics of the commercial real estate sector have changed dramatically since the early 1990s. Public markets now play a much larger role in commercial real estate financing, due to the development of the Commercial Mortgage-Backed Securities (CMBS) market in the early 1990s. The success of the CMBS market then contributed to tremendous growth in the secondary market for distressed properties. The CMBS market has grown to more than $550 billion. In the mid-1990s, Real Estate Investment Trusts (REITs) also became a major force in financing CRE, with more than a seven-fold increase in market size in the past 10 years.[14] It also appears that the CMBS and REIT markets have taken on a larger share of the traditionally higher-risk types of loans.

A recent FDIC study in the Atlanta MSA found that "(I)nsured institution risk controls and monitoring programs have improved significantly since the early 1990s. Overall, bank management has implemented more effective grading systems, improved control and approval limits, and adequate loan review procedures. Bankers understand current conditions and issues in submarkets and have access to a broader range of market information."[15] A study by the Federal Reserve Bank of Philadelphia in 2005 also noted that "current real estate underwriting and risk management practices are considered to be materially better than in the late 1980s and early 1990s, and there is presently no evidence of emerging systemic problems in the banking sector."[16]

These improvements in CRE lending were also recognized by the Basel Committee. Under the Basel II standardized approach, loans secured by commercial real estate will generally be assigned to the 100 percent risk weight basket.[17] However, in certain circumstances, mortgages on office or multi-purpose commercial premises may be assigned to the 50 percent risk weight if they meet certain LTV and other requirements.[18] We believe that, as in Basel II, real estate lending should be treated through two categories, interest producing real estate (IPRE) where favorable treatment is given to loans secured by buildings with a high occupancy rate and a strong history of revenue generation, and high volatility commercial real estate (HVCRE) which would fall into a

---

[14] FDIC, "Supervisory Insights: Assessing Commercial Real Estate Portfolio Risk." (June 25, 2004).

[15] Id. at 4.

[16] Federal Reserve Bank of Philadelphia, SRC Insights, "SVP Commentary on Top Commercial Real Estate Trends." (Second Quarter 2005). The study noted that there were poorly managed CRE concentrations in some institutions, and that bank supervisors should monitor CRE lending carefully.

[17] Basel II Accord par. 64.

[18] Basel II Accord par. 64, fn.29.

higher risk weighting and include loans to speculative real estate developments.[19] However, we also believe favorable treatment should be given to those acquisition, development and construction (ADC) loans that are secured by significant equity from the developer or legally binding pre-sale or pre-lease commitments.

On January 10, 2006, the Federal banking agencies issued proposed guidance on concentration and other risks associated with commercial real estate.[21] While we have not yet assessed the details of the proposed guidance, we think it is probably a better approach to require banks to make safe and sound loans than to impose excessive, across-the-board capital charges that would have a negative impact on the entire real estate industry. Neither current charge off experience, nor agency-conducted studies, support such a capital charge. We therefore urge that the agencies consider treating these loans through the Basel II framework of IPRE and HVCRE designations with an eye towards treating pre-leased/pre-sold ADC loans more favorably, and address safety and soundness issues through normal supervisory systems.

Conclusion

In conclusion, the NAR supports the efforts of the Federal banking agencies to improve the current Basel I standards in order to make this standard more risk sensitive and to lessen the potential competitive issues that may arise when Basel II is finalized. The NAR believes that this effort would be advanced by authorizing a lower risk weight basket for these assets that would more accurately reflect their risk and the treatment of such loans under Basel II. We also believe that the proposal should be modified to reflect various forms in which PMI may be used to mitigate credit risk. The NAR believes that a
punitive capital charge on non-traditional mortgage loans is not appropriate, and that any safety and soundness concerns with these products should be dealt with through the supervisory process. We likewise oppose a punitive capital charge for commercial real estate loans, which, according to the banking agencies, are performing well, and being underwritten prudently. Finally, as a general matter, we do not believe that the capital standards should impose a higher capital requirement for collateralized loans when a banking organization could make the same loan without collateral. We thus oppose assigning second liens and home equity lines of credit to a risk weight in excess of 100 percent.

We hope that you find these comments helpful. If you have any questions, please feel free to call Jeff Lischer at 202-383-1117.

Sincerely,

Thomas M. Stevens

[19] See discussion above on multifamily residential mortgages and footnote 13.

[20] See discussion above on multi-family residential mortgages and footnote 13.

[21] Federal banking agencies, “Concentrations in Commercial Real Estate Lending, Sound Risk Management Practices,” (January 10, 2006).