November 3, 2003

Ms. Jennifer J. Johnson
Secretary
Board of Governors of the Federal Reserve System
Twentieth Street and Constitution Avenue, NW
Washington, DC 20551
Attention: Docket No. R-1154

Dear Ms. Johnson:

Members of the National Association of Affordable Housing Lenders (NAAHL) appreciate the opportunity to comment on the proposed Risk-Based Capital Rules, commonly known as the Basel proposals.

By way of introduction, NAAHL represents America's leaders in moving private capital to those in need. Our 168 members include 71 insured depository institutions, non-profit providers, GSEs, insurance companies, pension funds, foundations, and other professionals. Our mission is to increase private capital lending and investing in low- and moderate-income communities.

We are concerned about a potential unintended consequence of the proposed rules that could affect adversely the amount of equity capital invested in affordable housing and community and economic development. The proposal appears to be in conflict with 12 CFR Part 24, the regulation governing investments that are designed primarily to promote the public welfare.

THE GOOD NEWS

The vital role of these investments in the U.S. is clearly recognized in part of the proposals. It is apparent that thoughtful U.S. bank regulators, working with those of other nations, negotiated a special rule for "Legislated Program Equity Exposures". This section wisely preserves the current capital charge on most equity investments made under legislated programs, "recognizing this more favorable risk/return structure and the importance of these investments to promoting public welfare goals." Insured depository institutions investing as a result of such programs therefore would set aside, by and large, the same amount of capital for CRA equity investments under the new rules as they do now – about $8.00 for every $100 of capital invested.

Given that CRA investments in affordable housing and community and economic development all have a different risk/return profile than other equity investments, that treatment is very appropriate. Based on experience to date – and in the U.S. there is considerable experience – CRA equity investments may well provide lower yields than other equity investments. They also have much lower default rates and volatility of returns than other equity investments. For example, Ernst and Young reported in 2002 that the loss experienced from housing tax credit properties over the period 1987-2000 was only .01% on an annualized basis. <u>It is important that the final regulations make clear that "investments in CEDES" (CRA equity investments) comprise all types of activities that are eligible for bank investment under Part 24 as</u>

"Legislated Program Equity Investments" that are held harmless from higher capital charges.

THE PROBLEM

The "materiality" test of the proposed rules is of great concern (cf page 45927 of the proposed rules). The materiality test requires institutions that have, on average, more than 10 percent of their capital in ALL equity investments, to set aside much higher amounts of capital on their non-CRA investments, such as venture funds, equities and some convertible debt instruments. As drafted, this calculation includes even CRA investments that are specifically held harmless from the new capital charges. At the end of the day, it sets up unfair competition between investments in "CEDES" and all other equity investments for space in the "materiality bucket". It also sets up an unfair competition between CRA investments that are equity investments, and those that are not (like mortgage-backed-securities and loan pools).

Having to include "CEDE" investments, with their very different risk/reward profile, in the proposed "materiality" bucket of more liquid, higher-yielding, more volatile equity exposures will have an unintended chilling effect on the flow of equity capital to those in need. Some insured depository institutions that meet the credit needs of their communities with substantial investments in affordable housing tax credits and/or Community Development Financial Institutions, currently approach, or even exceed, the 10 percent cap just from CRA-qualified investments alone.

While the proposed rule would grandfather these institutions' current levels of investment for 10 years, it also raises a red flag discouraging comparable levels of equity investment in low- and moderate-income communities going forward. If the test is adopted as proposed, it will put pressure on depository institutions to minimize investments in low yielding, less liquid CRA equity investments, to avoid triggering the much higher capital charges on, and thus reducing the profitability of, non-CRA equity investments. These higher capital charges will double on publicly-traded equities, and triple or quadruple on non-publicly traded ones.

We understand that the rules will initially apply only to the biggest banks. Yet we believe it is fair to say that regulators expect that most other insured depository institutions will comply, sooner or later, and some banks will voluntarily comply immediately, as a matter of best practices. It makes no sense to set up a conflict between the profitability of non-CRA equity investments, and the level of CRA-qualified equity investments. Depository institutions' support for affordable housing and community revitalization is well-established public policy in the United States. Numerous, recent studies, including those conducted by both the U.S. Treasury Department and the Federal Reserve Board, document that programs supporting these goals have had considerable positive impact on the nation's low- and moderate-income communities, with little or no risk to investors.

THE SOLUTIONS

First, it is important that the rules make clear that "investments in CEDES" comprise all types of activities that are eligible for bank investment under Part 24 as "Legislated Program Equity Investments" that are held harmless from higher capital charges. **Second,** the rules should exclude all CRA-related equity investments that qualify under the Part 24 regulations from the materiality test calculation. **Third**, the proposal that SBIC investments receive only a "Partial Exclusion" from higher capital charges should not be expanded to include any other CRA-related equity investments. **Fourth**, the ANPR proposes a "cliff effect", whereby if total equity investments

and/or SBIC ones exceed 10% of capital, all of the non-CRA and SBIC equity investments then require higher capital. We suggest that only the additional equity investments above the 10% level should require more capital.

These suggestions are intended to prevent disrupting an important marketplace serving accepted U.S. public policy goals, and also to preserve a depository institution's flexibility to respond to the credit needs of its community without regard to the form of that response. We stand ready to meet with you or provide you with additional information and any form of assistance that will be useful in deliberations on these rule proposals.

Sincerely yours,

Judith A. Kennedy