MORTGAGE BANKERS ASSOCIATION

March 25, 2015

Mr. Stefan Ingves
Chairman
Basel Committee on Banking Supervision
Basel, Switzerland

Reference: Consultative Document – *Revisions to the Standardised Approach for Credit Risk*

Dear Mr. Ingves:

The Mortgage Bankers Association[1] (MBA) appreciates the opportunity to comment on the Basel Committee on Banking Supervision's (Basel Committee) Consultative Document titled *Revisions to the Standardised Approach for Credit Risk* (Consultative Document).[2] The following are MBA's general comments.

Background

For banks in the United States, the rollout of Basel III included updates to the definition of capital, updates to the Standardized Approach (including risk weights for various asset categories and off-balance sheet positions), and updates to the Advanced Approach used by the largest banks. The Basel Commission rolled out its definition of capital several years ago. The Consultative Document is for determining the appropriate risk-weighting regime for credit exposures for those using the standardized approach.

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[1] The Mortgage Bankers Association (MBA) is the national association representing the real estate finance industry, an industry that employs more than 280,000 people in virtually every community in the country. Headquartered in Washington, D.C., the association works to ensure the continued strength of the nation's residential and commercial real estate markets; to expand homeownership and extend access to affordable housing to all Americans. MBA promotes fair and ethical lending practices and fosters professional excellence among real estate finance employees through a wide range of educational programs and a variety of publications. Its membership of over 2,200 companies includes all elements of real estate finance: mortgage companies, mortgage brokers, commercial banks, thrifts, REITs, Wall Street conduits, life insurance companies and others in the mortgage lending field. For additional information, visit MBA's Web site: www.mba.org.

[2] Basel Committee on Bank Supervision, Consultative Document, Standards, Revisions to the Standardized Approach for Credit Risk, December 2014.

General Comments and Questions

Proposed Treatment of Single Family Mortgage Loans

Final U.S. Rule – The final U.S. rule retained the 50 or 100 percent risk weights to exposures secured by one-to-four family residential properties (residential mortgage exposures). Under the U.S. rule, residential mortgage exposures that are "prudently underwritten and that are performing according to their original terms[3]" receive a 50 percent risk weight, while all other residential mortgage loans, including junior liens, are assigned a 100 percent risk weight. A residential mortgage loan guaranteed by the federal government through the Federal Housing Administration (FHA) or the Department of Veterans Affairs (VA) will have a risk weight of 20 percent[4]. U.S. regulators considered and rejected a proposed approach in their Notice of Proposed Rulemaking (NPR) that would have included a framework for risk-weighting residential mortgages based on underwriting and product features, including loan-to-value ratios (LTV). Instead they decided to stick with the definition (prudently underwritten and performing) that was written as part of Basel I. MBA agrees with the U.S. Basel III risk-weighting of residential mortgages and believes that the Basel Commission should consider this more "principles-based" approach in coming up with its final standard.

Basel Commission's Proposed Risk Weights for Residential Mortgages – The Basel Commission's Consultative Document proposes to abandon the existing 35 percent risk-weighting and replace it with a regime that risk weights residential mortgages based upon two underwriting factors:

- LTV
- Debt Service Coverage Ratio (DSC)

The DSC is defined in a similar manner to the "back-end debt to income ratio" (DTI) in the United States, with one major difference. The DSC would be calculated using net income **after taxes**.

The ultimate risk weight for a loan would be determined using a look-up table with the LTV and DSC as the driving factors placing risk weights from 25 percent to 100 percent. The Consultative Document appears to give no credit for loans having a federal guarantee like FHA and VA loans. Further, it appears to ignore the favorable impact private mortgage insurance coverage has on reducing loss severity in the event of default.

MBA Objects to the Use of LTV and DSC – MBA believes that the housing and mortgage markets and infrastructure are so different when comparing various Basel nations that the rules-based approach using two underwriting characteristics will be flawed. Rather, MBA proposes that the Basel Commission adopt a more principles-based standard similar to the one used successfully for decades in the United States.

[3] OCC, Fed and FDIC, Basel III Final Rule, page 40.
[4] Ibid, page 259.

Well-underwritten loans that are performing should be the standard. That standard is broad enough to take into account loan-to-value, debt-to-income, credit score, level of documentation, characteristics of the loan itself, and other important aspects to the credit strength.

The Risk Weight Should Take Into Account Loan Seasoning – The Consultative Document uses LTV and DSC at origination, and does not allow updates after a loan seasons for several years. MBA notes that defaults generally occur in the early years of a mortgage, and loans that have seasoned without delinquency should be granted lower risk weights. If the Basel Commission moves forward with the regime for mortgages in its Consultative Document, it should allow for periodic updating of the LTV and DSC.

Government Insured Loans and Loans with MI Coverage – The final rule should allow reduced risk weights for loans insured or guaranteed by the government or by private mortgage insurers, assuming the government or insurer is deemed creditworthy under the new rules.

Under the Consultative Document, the risk weight of a particular mortgage is dependent, in part, upon the LTV calculation. However, the Consultative Document appears to exclude loan level mortgage insurance (MI) from this calculation.

When backed by a strong counterparty, MI significantly reduces loss severity.[5] The primary effect of the Consultative Document's exclusion of MI from LTV calculations will be to shift additional costs onto prospective home buyers.

Finally, the Consultative Document will result in much higher pricing to consumers or will significantly delay the time it would take to save for a down payment, especially for first time home buyers who do not have significant equity to invest in their respective homes

Use of Income After Taxes in the DSC Is Wrong – The Consultative Document would require income in the DSC ratio to be net of taxes. MBA points out that there are significant differences in the tax regimes, social benefits, and government forms among the various Basel nations. MBA believes that taxes should not be part of the DSC ratio. Rather, MBA recommends that the Basel Commission use a more principles-based definition like well-underwritten loans that are performing. This will allow each country's regulator to define the most relevant measures in their unique circumstances.

Proposed Treatment of Commercial Real Estate Loans

Treatment of Commercial Real Estate Loans Structured as SPEs

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[5] *See, e.g., Global Criteria for Lenders' Mortgage Insurance in RMBS*, Fitch Ratings, August 3, 2012 and Lauri Goodman and Jun Zhu, Urban Institute, *Loss Severity on Residential Mortgages, February 2015, page 1.*.

Within the commercial real estate setting, Special Purpose Entitities (SPEs) are a tool used mostly by real estate developers and owners ("Sponsor") of operating commercial real estate (CRE) properties to isolate tort risk, facilitate cleaner ownership structures among various individuals and entities, and to make their projects attractive to commercial lenders. The use of a SPE enhances the "financeability" of a real estate project because it gives the lender greater comfort that the primary asset—the real estate project itself—will be shielded from many events that might prevent the lender from foreclosing on its loan.[6] Because it is an established and accepted approach, the SPE structure is preferred by banks. In addition, for CRE loans, SPE's are typically passive, with the borrower (Sponsor), not the SPE, making the operational decisions for the property. The SPE does not shield the borrower from malevolent acts, should the bank repossess the property.

According to the Consultative Document, a CRE loan would be classified as "specialized lending" if the following tests are met:[7]

- The exposure is typically to an entity (often a special purpose entity (SPE)) that was created specifically to finance and/or operate physical assets;
- The borrowing entity has few or no other material assets or activities, and therefore little or no independent capacity to repay the obligation, apart from the income that it receives from the asset(s) being financed;
- The terms of the obligation give the lender a substantial degree of control over the asset(s) and the income that it generates; and
- As a result of the preceding factors, the primary source of repayment of the obligation is the income generated by the asset(s), rather than the independent capacity of a broader commercial enterprise.

As specialized lending, the commercial loans structured as an SPE would fall under the income producing real estate (IPRE) subcategory.[8] The Consultative Document indicates that IPRE exposures will be risk-weighted at the higher of (1) the risk weight of the applicable counterparty, and (2) 120 percent.[9] This would result in a risk weight of at least 120 percent, or 20 percent higher than the existing 100 percent risk weight.

Given that the SPE structure is beneficial to and is a fundamental element of CRE lending, MBA is strongly concerned that the Consultative Document would provide for a punitive risked weight for SPEs. In fact, this is counter to the direction that U.S. regulatory agencies took when considering the 100 percent outflow treatment (the highest category) for CRE loans structured as SPEs in the Liquidity Coverage Ratio Final Rule:[10]

[6] Effective Use of Special Purpose Entities. David J. Sewell, (July 2006).
[7] Consultative Document, p. 33.
[8] See Consultative Document Specialized Lending subcategory IV, p. 34.
[9] Consultative Document, p. 34.
[10] Fed. Reg. 61444 (October 10, 2014).

> The agencies have also revised the outflow rates for committed credit and liquidity facilities to SPEs so that only SPEs that rely on the market for funding receive the 100 percent outflow rate. This change should address commenters' concerns about inappropriate outflow rates for SPEs that are wholly funded by long-term bank loans and similar facilities and do not have the same liquidity risk characteristics as those that rely on the market for funding.

Importantly, U.S. regulators recognized that CRE loans structured as a SPE do not share the same risk characteristics as other types of SPEs. We would strongly encourage the Basel Committee to reach a similar conclusion and eliminate the punitive risk weight for CRE loans that are structured as SPEs. Instead, we believe that the structure of the CRE loan - a SPE or non-SPE – should not be a material consideration in assigning the risk weight.

<u>Proposed Treatment of Commercial Real Estate Loans</u>

Basel III rules in the United States require that CRE exposures to receive a risk weight of 100 percent unless they are deemed to be high volatility commercial real estate exposures (HVCRE). HVCREs require a risk weight of 150 percent and are defined as any credit facility that finances or has financed the acquisition, development, or construction of real property unless the facility finances one-to-four-family residential mortgage property, or CRE projects that meet certain prudential criteria, including with respect to the LTV ratio and capital contributions or expense contributions of the borrower.

Under the current Basel standardized approach, the risk weight is based on the collateral provided, and the risk weight is set at 100 percent. The existing regime also provides national discretion to reduce the risk weight to 50 percent under certain, strict conditions.

In the Consultative Document, the Basel Committee is considering two options:

1. No recognition of the real estate collateral. Rather, the exposure would be deemed to be unsecured, and the risk weight assigned based upon the strength of the counterparty – with weights from 60 percent to 300 percent of the exposure.
2. Assigning a risk weight from a table of risk weights ranging from between 75 percent and 120 percent based upon the LTV ratio. The proposed risk weights are as follows:

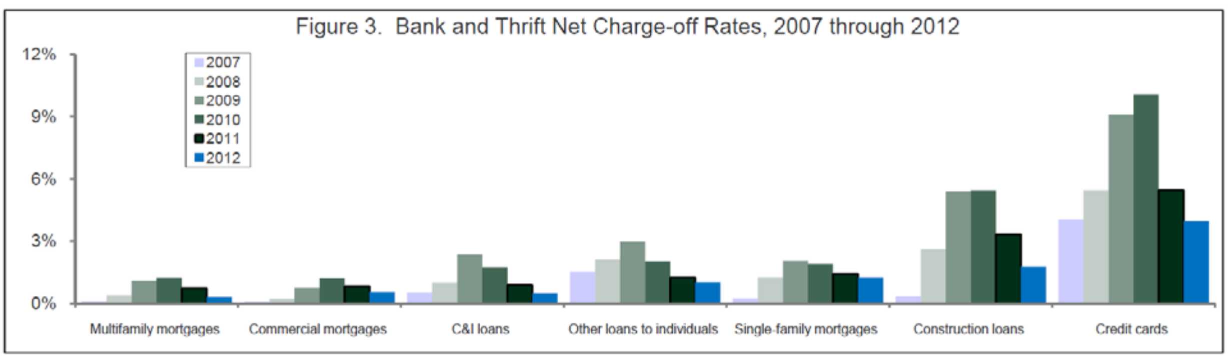
LTVs < 60 percent	Risk weight 75 percent
LTVs > or 60 percent but < 75 percent	Risk weight 100 percent
LTVs > or = 75 percent	Risk weight 120 percent

Regarding Option 1, the following rationale was provided in the Consultative Document:

> In view of the experience in numerous countries that commercial property lending has been a recurring cause of troubled assets in the banking industry over the past few decades, the Committee holds the view that commercial real estate collateral should not be considered a risk mitigant for regulatory purposes. As such, exposures secured by commercial real estate will be risk-weighted as unsecured exposures to the counterparty.[11]

MBA is concerned that this statement does not reflect the performance of U.S. bank holdings of CRE and multifamily loans during the most recent economic downturn. In a March 2013 MBA Research Datanotes[12] an analysis was performed regarding the performance of various bank asset categories that included: single family mortgages; credit cards; commercial and industrial loans; construction loans, other loans to individuals; CRE mortgages; and multifamily mortgages. In examining bank charge-offs during the 2007 to 2012 economic downturn, the report indicated:

> While delinquency rates represent the share of loans that are not paying on time, charge-off rates represent a bank's assessment of the share of the outstanding loan balance they are unlikely to get back….***Over the course of 2012, and throughout the credit crunch and recession, commercial and multifamily mortgages have had the lowest charge-off rates of any type of loan held by commercial banks and thrifts*.** In 2012, banks and thrifts charged off 0.55 percent of their balance of commercial mortgages and 0.32 percent of their multifamily mortgages, compared to charge-off rates of 0.84 percent and 0.74 percent respectively in 2011 (see Figure 3). By contrast depositories charged off 0.51 percent of their balance of commercial and industrial loans, 1.02 percent of other (non-credit card) loans to individuals, 1.26 percent of their one-to-four family residential loans, 1.77 percent of their construction loans and 3.95 percent of their credit card loans.[13]



For U.S. banks, the data shows that CRE and multifamily loans are clearly a risk mitigant. For construction loans, which experienced a higher charge–off rate for this period, U.S. regulators took action by instituting the HVCRE regime that increases the risk weight for acquisition, construction, and development loans that do not meet certain underwriting requirements. Given the strong performance of CRE and multifamily loans in the U.S., we do not share the view that such exposures should be risk-weighted as

[11] Consultative Document, p. 37
[12] See http://mba.informz.net/MBA/data/images/cmfdatanote030513.pdf
[13] MBA Research Datanotes, March 2013, p. 3, [Emphasis Added].

unsecured exposures to the counterparty. In fact, we see a lack of empirical support for such an approach for U.S. banks.

In addition to the lack of empirical support, the assignment of the risk weight based upon the strength of counterparty would be at odds with how CRE loans are frequently structured and analyzed by U.S. banks. U.S. bank CRE loan decisions are fundamentally driven by their assessment that the cash flow of the property will be able to adequately meet the debt service on the loan in a variety of market conditions. This conclusion is reached by sophisticated and detailed underwriting of the property. While, the counterparty may be considered in the credit decision, they are rarely a definitive factor. In the event of a default, banks look primarily to the underlying asset value to recover the outstanding loan balance, not the counterparty.

Importantly, by only considering the counterparty in the risk weight, not the asset fundamentals, banks would be required to make CRE credit decisions based upon the strength of the counterparty coupled with their existing underwriting criteria. This could potentially skew bank lending decisions towards low risk counterparties for CRE properties that meet their existing underwriting criteria. Such a risk weight methodology has the potential to limit bank lending to worthy projects whose sponsors (counterparties) are in the above 100 percent risk weight categories. This option forgoes current underwriting criteria and fosters the potential for ill-considered CRE credit decisions.

The second option, loan-to-value ratio, more closely ties the risk weight to the existing bank credit decision process. When making CRE credit decisions, banks take into consideration a wide variety of considerations. CRE underwriting is both an art and science. It is a combination of quantitative considerations (project financials, space configuration, current tenant base, etc.) and qualitative considerations (competitive position of the property, potential rent growth, surrounding area, etc). While the second option is far more aligned with the existing underwriting process than option one, additional consideration should be provided for the sophisticated and nuanced CRE lending underwriting process. Should the Basel Committee move forward with the second option for additional consideration, MBA strongly recommends that the risk weight not exceed 100 percent and take into consideration existing CRE lending underwriting practices.

Treatment of Warehouse Lines of Credit

Warehouse lending is the function of providing the necessary liquidity to an independent mortgage banking company to fund the closing of mortgages. It is a short-term revolving facility that funds a lender's inventory from the closing table to sale in the secondary market usually within weeks of initial funding. The mortgage note is used as collateral or the negotiable instrument that supports the interim financing until the mortgage is sold and delivered to the permanent investor, at which time the initial advance of the funds from the warehouse provider is repaid. However, in this case the mortgage has been pre-committed for sale to approved investors, FHA/VA, or committed for delivery into Ginnie Mae, Fannie Mae or Freddie Mac MBS. Those commitments are part of the collateral pool for the warehouse line. Mortgage bankers draw upon the line of credit to fund a mortgage at closing or to purchase a closed loan from another originator. The line of credit is then paid down weeks later when the loan is sold to the permanent investor.

Under U.S. regulatory capital rules, warehouse lines of credit are treated as commercial loan exposures and carry a risk weight of 100 percent.

The Consultative Document is rather nebulous as to where such warehouse lines of credit should be classified. We eliminated from consideration “specialized lending exposure” because warehouse lines of credit do not meet all of the four criteria in paragraph 21, page 33. Likewise, warehouse lending does not fall into any of the specialized lending categories discussed in paragraph 27 on page 34. Thus, it appears that by default warehouse lines fall into the senior corporate exposures category on page 33, paragraph 22. The Consultative Document uses two criteria in a look-up table to determine the risk weight: the borrower’s leverage and the borrower’s level of revenue. Most independent mortgage bankers have revenues of less than $50 million per annum. Likewise, due to the liquid nature of their balance sheets (loans held for sale that will be sold within a few weeks), warehouse lenders generally permit leverage greater than five times. Thus, the risk weight for such lines of credit would generally range from 110 percent to 130 percent (depending on annual revenues) – far in excess of the risk weight under U.S. Basel III. This risk weight regime clearly ignores the credit enhancement value provided by the highly liquid collateral.

MBA requests the Basel Commission to consider including mortgage loans held as collateral awaiting delivery to Ginnie Mae, Fannie Mae or Freddie Mac MBS in the definition of “Eligible Financial Collateral” in paragraph 92 on page 45 of the Consultative Document or somehow develop a risk weight more commensurate with the low amount of credit risk associated with such lines of credit.

Acquisition, Development and Construction Lending

Page 12 of the Consultative Document proposed that acquisition, development and construction (ADC) lending be treated as “specialized lending”. For specialized lending, the Basel Committee proposes to apply the higher of (a) the counterparty risk weight (determined on the basis of the counterparty’s revenue and leverage) or (b) 150 percent against exposures to ADC loans.

Under Basel III in the United States, ADC loans that meet certain underwriting criteria are treated like commercial real estate loans and carry a risk weight of 100 percent. The underwriting criteria includes but is not limited to: (1) loan to value ratio of no more than 80 percent and (2) contributed capital to the project in the form of cash or unencumbered readily marketable assets (or has paid development expenses out-of-pocket) of at least 15 percent of the real estate’s appraised ‘‘as completed” value. ADC loans not meeting these criteria are deemed to be HVCREs (see above) and require a risk weight of 150 percent.

MBA believes that the rule in the U.S. better reflects the risks associated with ADC loans. ADC loans with LTVs of less than 80 percent and cash or readily marketable assets of at least 15 percent of the "as completed" value provide for sufficient counterparty "skin in the game" and a liquid asset cushion in the event of overruns or unforeseen contingencies. Thus, they get a risk weight of 100 percent. MBA urges the Basel Committee to consider using this approach in the final rule. For the reasons previously described in the CRE and multifamily lending discussion, MBA strongly opposes the counterparty risk weight approach for CRE construction lending.

MBA appreciates the opportunity to share its observations with you. Any questions about the information provided herein should be directed to Jim Gross, Vice President Financial Accounting and Public Policy and Staff Representative to MBA's Financial Management Committee, at jgross@mba.org or George Green, Associate Vice President, Commercial/Multifamily Group, at ggreen@mba.org.

Sincerely,

David H. Stevens
President and Chief Executive Officer
Mortgage Bankers Association