Basel III Implementation

Basel III implementation must not unduly impair commercial/multifamily lending or CMBS liquidity.

In July 2013, U.S. banking regulators released the Final Basel III Regulatory Capital and Market Risk Rule, which implemented global standards developed by the Basel Committee on Banking Supervision. The final rule became effective on January 1, 2014, and many of the sections impacting commercial real estate mortgages and securities were implemented on January 1, 2015. In addition to Basel III, the Basel Committee has ongoing work streams that, if adopted by U.S. regulators, could have impacts on commercial and multifamily real estate financing. MBA continues to work with our bank portfolio lending members and banking regulatory agencies to address the commercial and multifamily real estate financing issues that arise under these existing or proposed standards.

BASEL III BACKGROUND

Risk-Based Capital for Commercial and Multifamily Loans
As a general matter, the final risk-based capital rule had a negligible impact on commercial real estate loans held in bank portfolios. The final rule maintained the 8 percent risk-based capital (RBC) requirement (100 percent risk weight) for bank mortgages for existing properties (non-construction mortgages) that are held in portfolio. For multifamily loans that meet certain underwriting conditions, RBC was reduced from 8 percent (100 percent risk weight) to 4 percent (50 percent risk weight).

High Volatility Commercial Real Estate Exposures (HVCRE)
The final rule had a substantial impact on some commercial acquisition, construction, and development loans (ADC loans). Under the final rule, HVCRE ADC loans receive a 12 percent RBC requirement (150 percent risk weight). HVCRE applies commercial ADC with a loan to value of greater than 80 percent, a borrower cash contribution of capital less than 15 percent of the project's "as completed" value or insufficient restrictions on withdrawal of capital during the life of the loan. In the years that followed, MBA expressed concerns about the HVCRE rule to the Federal Reserve, the Federal Deposit Insurance Corporation and the Comptroller of the Currency. In partial response to bank concerns, the agencies issued a set of FAQs in March 2015. In 2017, the banking regulators further responded with a proposed High Volatility Acquisition, Development or Construction (HVADC) rule that would replace the HVCRE rule. MBA commented that the proposal would largely have made the rule worse.

As a parallel alternate path, MBA also focused on a possible legislative solution. Those efforts ultimately led to the inclusion of an HVCRE provision in S. 2155, the Economic Growth, Regulatory Reform and Consumer Protection Act, which was signed into law in June 2018. That provision became effective immediately superseding contrary provisions in the banking agencies’ HVCRE rules. The agencies issued interim guidance in July 2018 and published proposed amendments in September 2018 to conform their HVCRE rules to the legislation. MBA supported the proposed amendments and submitted comments on interpretation and implementation issues in November 2018. See also MBA’s Issue Brief on the HVCRE rule.

GSE Multifamily MBS
For multifamily MBS that are guaranteed by Fannie Mae and Freddie Mac, the final rule maintained the existing 1.6 percent RBC requirement (20 percent risk weight) and the "substitution approach" that allows this RBC charge to be applied to the multifamily tranches that Fannie Mae and Freddie Mac guarantee.
Mortgage Servicing Rights
MSRs were not given favorable treatment in the final rule. The rule requires banks to deduct from the common equity component of tier 1 capital: mortgage servicing rights, deferred tax assets, and common stock purchases of unconsolidated financial institutions that individually exceed 10 percent of the common equity component of tier 1 capital. In addition, banks must deduct the aggregate of all assets in the above categories that exceed 15 percent of the common equity component of tier 1 capital from the common equity component of tier 1 capital. Any MSRs not deducted from capital receive a risk weight of 250 percent (a 20 percent capital requirement). This was a substantial increase from the prior 100 percent risk-weight for MSRs (8 percent capital requirement). The final rule allowed for a five-year phase-in, commencing January 1, 2014. MBA and its coalition partners strongly opposed this treatment of MSRs and will continue to seek modifications to the current rule.

Simplified Supervisory Formula Approach (SSFA)
The Simplified Supervisory Formula Approach (SSFA) is a formula-based approach for calculating RBC. Consistent with the Dodd-Frank Act's prohibition on regulator reliance on ratings, the SSFA replaces the ratings-based approach that had previously applied under the rule.

The SSFA generally does not increase RBC for the most senior CMBS tranches. For CMBS with subordination levels of 30 percent or greater, the SSFA will maintain the 1.6 percent RBC charge (20 percent risk-weight). This means that for CMBS bonds that comprise the top 70 percent of the CMBS waterfall structure, the SSFA will not result in increased RBC. However, for CMBS bonds with Junior AAA (less than 30 percent subordination levels), AA, A, BBB ratings, the SSFA will generate significantly higher RBC requirements. MBA recommends that the banking regulators recalibrate the SSFA to be less punitive on Junior AAA and AA securities.

ADDITIONAL BASEL COMMITTEE WORKSTREAMS

Liquidity Coverage Ratio
In September 2014, the banking agencies issued the Liquidity Coverage Ratio (LCR) final rule. The LCR is a supplementary rulemaking to Basel III that creates a new bank liquidity measure - LCR. The LCR is intended to ensure that large banks hold sufficient stock of "high-quality liquid assets" to survive a specified liquidity stress scenario. The final rule was responsive to MBA's comment letters by eliminating the highly detrimental treatment of Special Purpose Entities (SPEs), and it provided important clarifications regarding the unfunded portions of commercial real estate development loans and acquisition credit facilities. However, MBA had opposed the LCR treatment of CMBS adopted in the final rule and has recommended additional changes so that CMBS no longer on a bank's balance sheet would be excluded from the LCR calculation.

On December 21, 2018, the Federal Reserve Board, OCC and FDIC published a proposal to change applicability thresholds for regulatory capital and liquidity requirements. The proposal would make modifications to the Agencies' capital and liquidity rules by revising the criteria for determining the prudential standards that apply to large banking organizations operating in the US, specifically, (i) amending the scope of certain aspects of the regulatory capital rule and the Liquidity Coverage Ratio (LCR) rule; and (ii) re-proposing the scope of the proposed Net Stable Funding Ratio (NSFR) rule.

In a January 22, 2019 comment, MBA expressed concern about potential impacts on mortgages and lending, including potential adverse impacts on commercial mortgage-backed securities (CMBS) and construction lending. For example, the fact that instruments such as CMBS are not included within the definition of "high-quality liquid assets" (HQLA) for purposes of the LCR rule may affect bank appetite for such securities and the LCR rule treatment of disbursements under commercial real
estate construction loans could affect bank construction lending. We recommended that the Agencies should consider expanding the range of instruments considered to be HQLA, as appropriate, including adding high credit quality CMBS, and clarifying the treatment of construction loans. We also suggested that it may not be necessary or appropriate to finalize the long-proposed Net Stable Funding Ratio (NSFR) rule.

**Net Stable Funding Ratio**
A Net Stable Funding Ratio requirement would require banks to maintain a stable funding profile in relation to their on- and off-balance sheet activities. The Basel Committee finalized its Net Stable Funding Ratio proposal in December 2014, and U.S. regulators issued a Net Stable Funding Ratio proposed rule in May 2016. In comments on the proposed rule, MBA recommended that U.S. regulators should conduct a comprehensive study of the impact of the proposal and other new rules to determine their impact on credit availability before issuing any final rule. We cautioned that the Net Stable Funding Ratio would need to be carefully calibrated to avoid any unintended consequences for U.S. banks that could adversely affect bank support of the CRE industry. The agencies have not yet issued a final Net Stable Funding Ratio rule and, in a January 22, 2019 comment, MBA suggested it may not be necessary or appropriate to do so.

**Standardized Approach for Credit Risk**
In March 2016, MBA submitted its second comment letter on the Basel Committee’s Consultative Document on the Standardized Approach to Credit Risk. Under the most recent Consultative Document, bank capital charges for most commercial and multifamily real estate loans would not be changed. MBA’s letter commends the Basel Committee for withdrawing elements of its prior proposal that would have imposed punitive capital treatment for loans for commercial real estate properties that were organized as Special Purpose Entities (SPEs). MBA also supported the withdrawal of the proposal that would have established the capital charge for all CRE loans based solely on the credit profile of the borrower, not the property. The Consultative Document will not be considered by U.S. regulators until after it has been finalized by the Basel Committee. Provided that the Credit Risk proposed rule by U.S. regulators reflect MBA’s recommended changes, MBA would not oppose it.

**Step-in Risk**
In March 2016, MBA submitted a comment letter to the Basel Committee addressing the Committee’s Step-in Risk Consultative Document. Step-in risk involves the risk that a bank may provide financial support to an entity beyond or in the absence of any contractual obligations, should the entity experience financial stress. The proposal called for a new capital regime to address step-in risk. MBA strongly opposed this proposal because step-in risk is, among other things, adequately addressed by existing accounting rules.

In March 2017, the Basel Committee issued a revised “near final” proposal. The proposal would be considered by U.S. regulators only after it has been finalized by the Basel Committee. MBA submitted a comment May 15 recommending that the Committee explicitly grant US regulators and other national supervisors the flexibility necessary to avoid imposing capital, liquidity or other requirements that are not warranted by actual risks and to avoid imposing a duplicative layer of regulation. The Committee issued guidelines in October 2017.

**Fundamental Review of the Trading Book**
In January 2016, the Basel Committee issued its final Consultative Document on the Fundamental Review of the Trading Book (FRTB). If adopted by U.S. regulators, the approach described in the Consultative Document would dramatically increase capital requirements for bank trading book activities for CMBS and other structured securities. In November 2015, MBA participated in a coalition letter to US regulators that strongly recommended that they work to make modifications to
the FTRB proposal -- in advance of the U.S. regulatory agency consideration -- in order to avoid negative impacts on the U.S. market. MBA recommends that U.S. Regulators not adopt the FRTB proposal.

Regulatory relief
On October 31, 2018, the Federal Reserve Board, OCC and FDIC issued a request for information (RFI) seeking comments on a proposal that would establish four different risk-based categories for determining the applicability of the requirements under the agencies’ regulatory capital rule, liquidity coverage ratio rule, and proposed net stable funding ratio rule for domestic large banking organizations (LBOs). The impact of the proposal would be to ease requirements for mid-sized banks; it would not modify requirements for the largest banks.

Recommendation
MBA will take action to strongly oppose onerous new regulatory requirements that may adversely affect commercial and multifamily real estate finance, including adverse impacts on CMBS liquidity, as they arise, including the Basel Committee’s Step-in Risk and Fundamental Review of the Trading Book Proposals. We are monitoring and responding to developments regarding each of these regulatory requirements.

March 2019