NATIONAL ASSOCIATION OF REALTORS®

REALTOR®

The Voice For Real Estate®

700 Eleventh Street, NW
Washington, DC 20001-4507
202.383.1184 fax 202.434.9645
dlereah@realtors.org

David A. Lereah
Senior Vice President,
Chief Economist
RESEARCH

October 31, 2003

Office of the Comptroller of the Currency
250 E Street, SW
Public Information Room
Mailstop 1-5
Washington, DC 20219
Comments Re: Docket No. 03-14, RIN Number 1557-AC48

Ms. Jennifer J. Johnson
Secretary
Board of Governors of the Federal Reserve System
20th Street and Constitution Avenue, NW
Washington, DC 20551
Comments Re: Docket No. R-1154

Robert E. Feldman
Executive Secretary
Federal Deposit Insurance Corporation
550 17th Street, NW
Washington, DC 20429
Comments Re: RIN 3064-AC73

Regulation Comments
Chief Counsel's Office
Office of Thrift Supervision
1700 G Street, NW
Washington, DC 20552
Comments Re: No. 2003-27, RIN 1550-AB56

To Whom It May Concern:

The NATIONAL ASSOCIATION OF REALTORS® (NAR), representing over 950,000 real estate practitioners, would like to submit the following comments on the Advanced Notice of Proposed Rule Making governing the Risk-Based Capital Guidelines; Implementation of the New Basel Capital Accord. The NATIONAL ASSOCIATION OF REALTORS®, *The Voice for Real Estate*®, is the world's largest professional trade association. NAR is composed of

REALTORS® who are involved in residential and commercial real estate as brokers, salespeople, property managers, appraisers, counselors, investors, developers and others engaged in all aspects of the real estate industry.

Members belong to one or more of some 1,700 local associations/boards and 54 state and territory associations of REALTORS®. Additionally, thousands of REALTORS® are members of NAR's many institutes, societies and councils, designed to enhance their expertise and network with other professionals globally. These include the Certified Commercial Investment Member (CCIM), the Institute of Real Estate Management (IREM), the REALTORS® Land Institute (RLI), the Council of Real Estate Brokerage Managers (CRB), the Council of Residential Specialists (CRS), the Real Estate Buyer's Agent Council (REBAC), the Society of Industrial and Office REALTORS® (SIOR), the Counselors of Real Estate (CRE) and the Women's Council of REALTORS® (WCR).

As international developments have played an increasing role in how and where capital is invested throughout the world, NAR has expanded global real estate market opportunities for its commercial and residential members. Since NAR started its international operations program in the early 1950s, the Association has built a network of cooperative agreements with real estate associations around the world, and has actively expanded and developed this network. NAR has promoted international real estate education, development of technical standards and technical information exchange, and international real estate practice in a number of areas, including commercial outreach activity and development of an international real estate consortium.

NAR took a leadership role in helping organize the International Consortium of Real Estate Associations (ICREA) in 2001. ICREA's mission is to assist constituent members to efficiently serve their customers and clients through the development and maintenance of international business standards, products and services. Objectives of the consortium include technical standards for data transfer, an international referral system and advocacy, including promoting best practices worldwide.

New Basel Capital Accord

NAR supports the overall goal of the new Accord, which is to create regulatory capital standards that are more aligned with the underlying economic risks that a bank will incur. The new Accord will permit qualifying institutions to calculate their minimum risk-based capital requirements by using their own internal risk estimates, which we believe will promote strong risk management. The Accord is intended to provide an incentive for banks, in the form of lower capital requirements, to employ sophisticated modeling techniques, loss mitigation tracking tools and risk modeling tools. NAR believes that the objectives of the new Accord are important to ensure consistency and competitiveness among internationally active and domestic banks, particularly those that engage in real estate lending.

We believe, however, that the new Accord poses some adverse consequences for residential and commercial lending. Even though the capital charges on certain types of commercial real estate loans provide for optional treatments based on national discretion, the fact that real estate lending is treated differently overall in the new Accord will lead to a loss of credit opportunities in that sector. Real estate is vital to the U.S. economy because the housing sector directly accounts for about 15 percent of the total production and an additional 6 percent of economic activity is derived from indirect housing-related expenses.

The new Accord consists of three pillars, the most important of which is Pillar I. This Pillar consists of minimum capital requirements, which are the rules that a bank uses to calculate its capital ratios. The Pillar I capital requirement includes a credit risk charge that is measured by an Internal Ratings-Based Approach (IRB).

Credit Risks Under the Internal Ratings-Based Approach (IRB)

The IRB approach allows a bank to use sophisticated internal credit risk rating models and systems to measure capital adequacy. The IRB approach includes a foundation internal ratings based approach version and an advanced internal ratings based approach version. The foundation version means a bank has a system in place to accurately estimate for each credit exposure the probability that the borrower will default. Under the advanced approach, besides estimating the probability of default, a bank would have to estimate the likely size of the financial loss in the event of a default and an estimate of what the total amount borrowed would be at the point a likely default would occur.

Under the IRB approach, banks would have to classify their exposures into broad classes of assets. These classes include sovereign, bank, retail, equity and corporate. Within the corporate asset class there are five subclasses of specialized lending including project finance, object finance, commodities finance, income-producing real estate, and high-volatility commercial real estate. Income producing real estate refers to a method of providing funding to real estate such as multifamily buildings where the prospects for repayment of the loan depends on the rental payments coming in from the tenants or the sale of the building. High-volatility commercial real estate lending is the type of lending that could experience higher loss rate volatility (i.e., higher asset correlation) compared to other kinds of specialized lending.

Real estate lending is divided into income producing real estate and high- volatility commercial real estate categories. The risk weight for both of these categories can be calculated under the formula for the corporate asset risk class. If a bank qualifies to use the IRB approach then it can use the corporate asset risk class formula to determine the risk weights for income producing real estate and high-volatility commercial real estate. However, for high-volatility commercial real estate, banks will also have to apply a substitute asset correlation formula in lieu of the asset correlation function currently assigned to the corporate risk class formula. The reason for the substitute asset correlation formula is the belief that high-volatility commercial real estate loans tend to default at the same time, which necessitates higher capital requirements.

Only residential and commercial construction loans are included as high-volatility commercial real estate under the corporate asset exposures. These are loans where the source of repayment on the loan is dependent on the future sale of the property or cash flows from unknown sources. In other words, a construction loan on a non pre-sold home would have the same asset correlation as a loan to build a large commercial development whose future tenants are unknown. NAR believes that this will cause banks not to provide acquisition, development and construction loans because these loans will have the same capital expense as those associated with more risky lending activities.

NAR contends that improvements in underwriting such as requiring more borrower equity, better appraisal procedures and improved credit scoring techniques have made commercial real estate lending less volatile, as demonstrated by the industry's reduced loan loss experience over the last ten years or so. Also, through securitization vehicles like commercial mortgage backed securities (CMBS), real estate's role in the global markets has increased which has led to better transparency and discipline, greater liquidity and a closer examination of commercial lending activity worldwide. NAR believes that all commercial real estate should be categorized as income producing and the high-volatility commercial real estate category should be eliminated.

Banks that fail to qualify to use the IRB approach will have to use the preset minimum numerical capital ratios to determine the risk weights for income producing real estate and high-volatility commercial real estate. As a result, the specific risk weights could range from 75% to 625% for income producing real estate and 100% to 625% for high-volatility commercial real estate. In other words, if a bank cannot use the IRB approach then it will incur higher capital charges for income producing real estate and high-volatility commercial real estate. As we previously indicated, these risk weights seem to be arbitrarily high and not reflective of the advancements made in lending to the commercial real estate sector.

Competitive & Cost Disadvantages for Smaller Banks and Inconsistent Worldwide Enforcement

The new Basel Capital Accord will give some degree of regulatory capital relief to a limited number of banks that qualify, in exchange for investing in systems and infrastructure intended to improve risk management. NAR is concerned that this will enable only the largest banks that can invest in sophisticated capital allocation models, to effectively operate with a lower capital ratio than smaller banks. These banks will be able to grow and compete more aggressively for both assets and liabilities to the disadvantage of smaller banks.

Small banks do not have the resources to implement the complex internal risk weighting models that the new Accord requires. The estimates range from $50 million to $200 million per bank to implement the procedures required under the new Accord to evaluate and control risk exposures. The costs associated with learning a new regulatory system, installing new software and retraining staff will be prohibitive to small banks. Small banks could become acquisition targets of banks that qualify under the new Accord, which could result in further consolidation of the industry. NAR believes that maintaining competitive equality for smaller banks is important to serving smaller markets, especially rural communities.

Finally, NAR is concerned that foreign banks will have a competitive advantage because the prescriptive capital rules could be haphazardly enforced outside the United States while being strictly enforced here. Similarly, it is foreseeable that there will be great difficulties in applying a complex set of rules equally across a wide array of banking systems throughout the world. In this regard, it seems the complexities of the new Accord will work against the goals of the original Accord.

Conclusion

NAR is concerned that under the new Basel Capital Accord financial institutions will divert their resources away from real estate lending and make loans to those sectors that do not require as much capital. If the new Accord is enacted as currently envisioned, banks whose portfolio is now geared toward real estate lending would refocus their lending strategies away from real estate and towards investments requiring lower capital charges.

NAR appreciates the opportunity to comment on the Advanced Notice of Proposed Rule Making governing the Risk-Based Capital Guidelines; Implementation of the New Basel Capital Accord. If you have any questions please contact Peter Morgan at 202-383-1233 or pmorgan@realtors.org.

Respectfully Submitted,

David Lereah

David Lereah
Senior Vice President & Chief Economist