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Jamie Gregory, Deputy Chief Lobbyist

500 New Jersey Ave., NW
Washington, DC 20001-2020
Ph. 202-383-1194 Fax 202-3837580
www.REALTOR.org

October 22, 2012

Mr. Robert deV. Frierson
Secretary
Board of Governors, Federal Reserve System
20th Street and Constitution Avenue, N.W.
Washington, D.C. 20551
RE: Docket NoR-1442 and
RIN No. 7100 AD 87

Mr. Robert E. Feldman
Executive Secretary
Attention; Comments/Legal ESS
Federal Deposit Insurance Corporation
550 Seventeenth Street, N.W.
Washington, D.C. 20429
RE: RIN 3064-AD 96 and
RIN 3064-AD 95

Office of the Comptroller of the Currency
250 E Street, S.W., Mail Stop 1-5
Washington, D.C. 20219
RE: Docket ID OCC-2012-0009 and
Docket ID OCC-2012-0008

Re: Regulatory Capital Rules: Standardized Approach for Risk Weighted Assets; Market Discipline and Disclosure Requirements

Re: Regulatory Capital Rules: Regulatory Capital, Implementation of Basel III, Minimum Regulatory Capital Ratios, Capital Adequacy, Transition Provisions, and Prompt Corrective Action[1]

Dear Sirs:

I am writing on behalf of the more than one million members of the National Association of REALTORS® (NAR), and its commercial affiliates: CCIM Institute, Institute of Real Estate Management, REALTORS® Land Institute, and Society of Industrial and Office REALTORS® to provide our comments on proposed changes to the capital rules applicable to insured depository institutions and their holding companies. REALTORS® are involved in all aspects of the residential and commercial real estate industries and belong to one or more of some 1,400 local associations or boards, and 54 state and territory associations of REALTORS®.

Since our membership will be directly affected by the cost and availability of mortgage finance, the proposed regulation is of critical importance to our organization.

[1] Unless indicated otherwise, all references in this letter to the "proposal" or "proposed regulation" refer to the Standardized Approach rulemaking.

NAR supports strong capital requirements for our banking industry, and agrees with the goals behind the proposed rulemaking. The recent financial crisis illustrates the need for prudent regulations and a strong capital backstop for depository institutions and their holding companies. We commend the agencies for taking a hard look at the current capital requirements, and agree with many of the suggested changes contained in the notice of proposed rulemaking (NPR). However, we believe that some provisions in the proposed regulation are not consistent with the goals of the Basel Accord, and would have negative, unintended consequences for residential and commercial real estate and a broader economic recovery. We are especially concerned about the impact of these provisions on smaller, community oriented banks that were not responsible for the financial crisis, and that are the mainstay for mortgage loans in many of our cities and towns. The sheer volume of regulations surrounding the mortgage finance business has resulted in consolidating and constraining the number of institutions offering mortgage credit to consumers, and we believe our specific suggestions balance the need for strong capital requirements, while also ensuring access to home loans and competition among lenders.

This letter will address the provisions in the proposal that we find most troubling.

Residential Mortgage Lending

I. Risk Weights for First Lien Mortgage Loans

A. Current Capital Requirement

Under currently applicable risk based capital rules, a prudently underwritten first mortgage with a loan-to-value ratio (LTV) of 90 percent or less, is given a risk weight of 50 percent. All other mortgages, including second liens and advances on home equity lines of credit, are given a risk weight of 100 percent. In determining the LTV for a loan, the agencies will take into account the existence of credit enhancements, such as private mortgage insurance (PMI). Thus, the existence of PMI on a low down payment loan will enable the lender to use risk weights applicable to mortgages with a 90 percent or lower LTV.

B. Proposed Capital Treatment

Under the proposal, mortgages are divided into two categories, and then subdivided based on the LTV ratio of the mortgage. Unlike the current rules, a credit enhancement such as PMI does not count when determining the LTV ratio. Therefore, a first-time homebuyer who makes a 5 percent cash down payment, and who obtains mortgage insurance on the loan, will be considered as having a 95 percent LTV loan for capital purposes. Under the proposal, the capital charge for this loan would be double that of the current capital requirements.

Category 1 mortgages have lower capital charges than Category 2 loans. In order to be a Category 1 loan, the mortgage must meet the following requirements:

- It must be a first mortgage;
- The term may not exceed more than 30 years;
- The loan cannot have a balloon payment;
- The loan may not have a negative amortization feature;
- The loan cannot allow for the deferment of principal payments;
- It must be underwritten by taking into account all of the borrower's obligations, including taxes, insurance and assessments;
- Income information used to underwrite the loan is documented and verified;
- The creditor must have made a reasonable determination that the borrower can repay the loan using the maximum allowable interest rate in the first five years; and
- If an ARM, the amount of interest rate increase is capped at 2 percent per year, and no more than 6 percent over the life of the loan.

Category 2 includes all mortgage loans that are not Category 1 loans, including second liens and Home Equity Lines of Credit (HELOC) that are junior to a first mortgage.

The risk weight is then found by looking at the LTV. For Category 1 loans, the following risk weights apply:

LTV	Risk Weight
Equal to or less than 60%	35%
Greater than 60% but equal to or less than 80%	50%
Greater than 80% but equal to or less than 90%	75%
Greater than 90%	100%

For Category 2 Loans, the following risk weights apply:

LTV	Risk Weight
Equal to or less than 80%	100%
Greater than 80% by equal to or less than 90%	150%
Over 90%	200%

C. Discussion

1. Impact of Capital Requirements on Price and Availability of Mortgage Loans

Regulatory capital requirements are an important consideration for regulated banking institutions. The more capital that is required, the higher the "cost" for the bank to make the loan. Therefore, when the capital charge for a loan increases, the lending institution will either raise the interest rate or other fees to the consumer for that loan, or divert its resources to a different activity, or both. In short, the higher the capital charge, the more costly the loan will be to homebuyers and the less credit available for mortgages.

Under the proposal, the regulatory capital charge on well underwritten, fixed rate, 30-year, first mortgages with an LTV between 80 percent and 90 percent will increase by 50 percent, and if the LTV is over 90 percent, the capital charge will increase by 100 percent. This will have a dramatic impact on the majority of home purchasers in the United States,[2] and will result in more expensive mortgages for all but the wealthiest segments of our communities. First-time homebuyers and minorities will be the most significantly disadvantaged. However, the adverse effects will be felt throughout the housing market, since for the overriding majority of growing families, the ability to move up to a larger home depends on the funds received from the sale of their "starter" home.

Under the Basel framework, there should be a strong correlation between the capital charge for an asset, such as a mortgage loan, and the risk to the bank presented by that asset. We believe this is a fundamental tenet of "risk based" capital. The proposal seeks to justify the increased capital requirements for mortgage loans based on the defaults in subprime mortgages experienced during the fiscal crisis that began in 2007. However, a careful analysis of the data indicates that traditionally underwritten mortgages, such as those described in the proposal as "Category 1" loans, are safe assets that should not be penalized through higher capital requirements. In particular, the data demonstrates that high LTV mortgages can be safely made, and that when appropriately underwritten, do not have rates of default that would justify the proposed risk weights.[3] Further, if higher LTV loans are protected by private mortgage insurance or other credit enhancements, the

[2] From mid-2010 through mid-2011, 71 percent of all homebuyers made a down payment of 20 percent or less, and 56 percent made a down payment of 10 percent or less. National Ass'n. of Realtors, *Profile of Home Buyers and Sellers 2011*.
[3] University of North Carolina's Center for Community Capital and the Center for Responsible Lending, "Balancing Risks and Access: Underwriting Standards and Qualified Residential Mortgages" 5 (2012) ("Loans with low downpayment requirements have been originated safely for decades…") (hereinafter "UNC/CRL study.")

expected losses on loans that do fail would be reduced by the insurance payments, adding an additional layer of safety for the bank.[4]

2. Category 1 Mortgages Are Safe and Sound Loans

The financial crisis that began in 2007 resulted from a bubble in housing prices that was fed, in large part, by poorly underwritten mortgage loans. The worst performing loans had non-traditional features, such as the option to defer the payment of principal or interest, or were adjustable rate loans that imposed sharp increases in interest rates on the consumer after a relatively short initial period.[5] Many of these loans were made without documenting the income or assets of the borrower.[6] One characteristic common to all of these poorly performing loans was that they did not accurately consider the ability of the borrower to repay the debt from income, but instead relied upon the expectation that the value of the collateral was ever increasing.[7] These loans would not be considered Category 1 mortgages as described in the proposal.

The requirements for a Category 1 mortgages are very similar to the proposed requirements for a Qualified Mortgage (QM) under section 1412 of the Dodd-Frank Act. A lender that originates a QM is presumed to have met the statutory requirement that the originator has made a good faith determination that the borrower has a reasonable ability to repay the loan according to its terms. Category 1 mortgages include most of the standards set out in the proposed definition of a QM. However, unlike the presumption that arises under the QM provisions, the creditor must still make an independent determination that the borrower has a reasonable ability to repay the mortgage, even if all of the underwriting and product restrictions for Category 1 are satisfied. Thus, in some respects Category 1 loans can be viewed as requiring more stringent underwriting than QM loans, since Category 1 does not include a presumption that the "ability to repay" test has been satisfied. As a result, banks will have to document the basis for the conclusion that the borrower has a reasonable ability to repay the mortgage. One can expect that this documentation, and the basis for the bank's conclusion, will be subject to review as part of a bank's periodic supervisory examination.

In short, Category 1 describes mortgages with traditional terms, subject to full borrower documentation requirements, and that do not contain any of the problematic features tied to the subprime crisis. Further, these loans will be stringently underwritten, and the bank will have to establish that when the loan was made, the borrower had a reasonably ability to repay the mortgage according to its terms. These will be very high quality loans.

Historically, the default rate on traditionally underwritten loans was extremely low, even though many of these loans had LTV ratios in excess of 80 percent (often protected by mortgage insurance or guaranteed by the FHA or VA). For example, according to CoreLogic, Inc.,[8] mortgages with LTVs between 95 and 99 percent average 17 percent of originations from 1990 through 1999. Foreclosure rates on FHA financed mortgages, which lend to LTVs greater than 95%,[9] averaged 1.6

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[4] We believe that private mortgage insurance should only be recognized when provided by a company with strong financial resources and stringent prudential supervision. We suggest that the regulatory agencies, in coordination with state insurance agencies, and with input from affected parties and the public, develop appropriate standards for determining the financial strength of mortgage insurance providers.

[5] Remarks of Federal Reserve Chairman Bernanke before Women in Housing and Finance and the Exchequer Club, January 10, 2008, available at: www.federalreserve.gov/newsevents/speech/bernanke20080110a.htm; Chairman Bernanke's remarks at the Fed. Res. Bank of Chicago's 43rd Annual Conference on Bank Structure and Competition, May 17, 2007, available at www.federalreserve.gov/newsevents/speech/bernanke20070517a.htm. OCC testified before Congress that product features such as failure to document income, "teaser" rates, or terms permitting negative amortization or interest-only payments contributed significantly to the high levels of delinquencies and foreclosures since 2007. *Understanding the Implications and Consequences of the Proposed Rule on Risk Retention Before the H.Comm. On Fin. Serv.*, 112th Cong. (April 14, 2011) (statement of Julie Williams, Chief Counsel, OCC, p12).

[6] Federal Reserve Board Chairman Bernanke's remarks at the Fed. Res. Bank of Chicago's 43rd Annual Conference on Bank Structure and Competition, May 17, 2007, available at www.federalreserve.gov/newsevents/speech/bernanke20070517a.htm; Report of the Financial Crisis Inquiry Commission at 194 ("By 2006 about half of the mortgages sold (into a securitization vehicle) were no-doc or low-doc.")

[7] Remarks of Federal Reserve Board Chairman Ben Bernanke at the Federal Reserve System Conference on Housing and Mortgage Markets, Dec. 4, 2008. ("One unfortunate consequence of the rapid increases in house prices was that providers of mortgage credit came to view their loans as well-secured by the rising values of their collateral and thus paid less attention to borrowers' ability to repay.)

[8] CoreLogic. "The MarketPulse." June 2012

[9] 57% of FHA loans originated between 1990 and 1999 had an LTV greater than or equal to 95%; Actuarial Review of the Mutual Mortgage Insurance Fund FY2008

percent over this same period when the average foreclosure rate was just 1.0 percent for all mortgages.[10] The high number of defaults and delinquencies that we experienced starting in 2007 were particularly concentrated in a subset of subprime and "near prime" mortgages.[11] As noted, these loans commonly had non-traditional features, such as negative amortization, low teaser rates, or no requirement to document income or assets. These features are not permissible for a Category 1 mortgage.

3. Penalizing Category 1 Mortgages with Loan-to-Value Ratios in Excess of 80 Percent is not Justified by the Data

As noted previously, under the proposal, well underwritten traditional mortgage loans with an LTV in excess of 80 percent would be subject to significantly higher capital charges. There is no question that the lower LTV loans perform better than higher LTV loans, when compared to loans with similar features and made subject to similar underwriting standards. However, the impact of higher LTV ratios on loan defaults is mitigated when non-traditional lending practices are prohibited, and other appropriate underwriting standards are applied.[12] Thus, sound underwriting and product features, such as fully documenting the income of the borrower, requiring at least some "real" down payment from the purchaser,[13] and avoiding exotic or non-traditional mortgage products, appear to have a more significant impact on reducing default rates than larger down payments.

An analysis of data from CoreLogic Inc. on high quality loans[14] originated between 2001 and 2008 shows that increasing down payments in 5 percent increments has a negligible impact on default rates.[15] Specifically, as shown in the chart below, on loans that already meet strong underwriting and product standards, moving from 5 percent to a 10 percent down payment reduces the default experience by an average of only two- or three-tenths of one percent. Further increasing the minimum down payment to 20 percent results in only an improvement in default performance of about eight-tenths of one percent.

	2002	2003	2004	2005	2006	2007	2008
Reduction in default rate by increasing down payment from 5% to 10%	0.2%	0.1%	0.3%	0.3%	0.2%	0.5%	0.2%
Reduction in default rate by increasing down payment from 5% to 20%	0.6%	0.3%	0.7%	0.8%	0.8%	1.6%	0.6%

The slight improvement in loan quality indicated by this data simply does not support the proposed 50 percent increase in the capital charge for mortgages with an LTV in excess of 80 percent, and the 100 percent increase in the capital charge for mortgages with an LTV in excess of 90 percent.

Additional evidence is obtained by reviewing the performance of FHA guaranteed mortgages. FHA purchase loans have an average LTV of 96 percent,[16] and all loans currently guaranteed by the FHA have an average LTV of 93 percent. But because FHA required strong underwriting, including documentation, its portfolio has performed far better than subprime and Alt-A loans which did not have the same sound underwriting and loan characteristics. The chart below compares the foreclosure rate for FHA loans with subprime and Alt-A loans from March, 2007 through March, 2011.

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[10] Mortgage Bankers Association. National Delinquency Survey.

[11] Id. at 2.

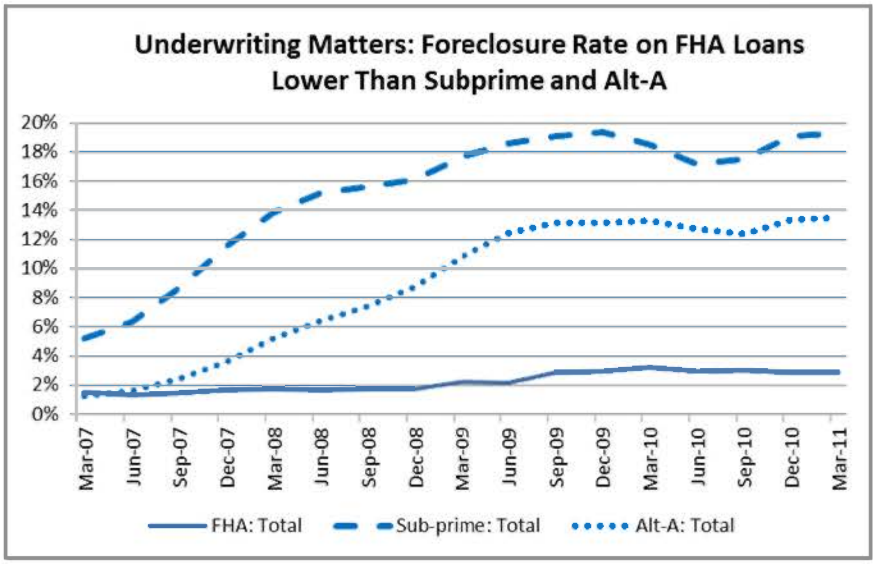
[12] See, e.g. UNC/CRL study at 15, 18: ("(E)ven without imposing any limits on LTV, DTI, or FICO scores, loans meeting the QM product feature definition have performed better than most other loan segments, including FHA loans and even prime conventional loans.") ("(P)roduct features, not LTV, were significant drivers of default over this time period.")

[13] One of the most problematic practices during the bubble years was 100 percent financing, including the use of "piggy back" loans to reduce artificially the LTV on the first loan to 80 percent.

[14] Loan attributes: Fully documented income and assets; fixed-rate or 7 year or greater ARMs; no negative amortization; no interest only loans; no balloon payments; 41 percent total debt-to-income ratio; mortgage insurance on loans with 80 percent or greater LTV; and no maturities greater than 30 years. Source: Data from CoreLogic, Inc. Analysis by Vertical Capital Solutions for Genworth Financial and the Community Mortgage Banking Project.

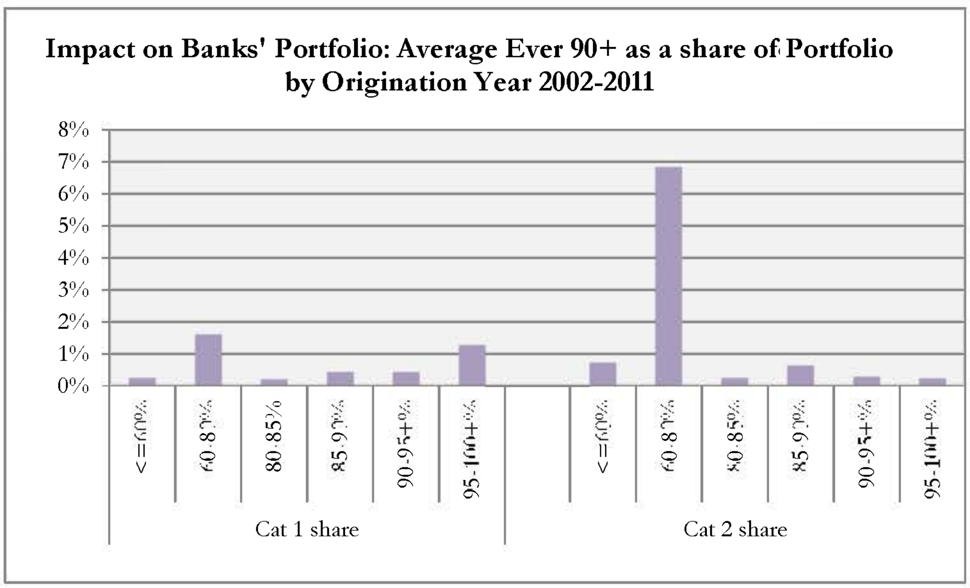
[15] The data includes mortgages held in portfolio as well as those sold to Fannie Mae and Freddie Mac.

[16] FHA Quarterly Report to Congress, FY 2012 3rd Quarter at 7.



This again demonstrates that sound underwriting, full documentation, and traditional loan terms are key, and that higher LTV loans can be made safely and soundly.

The data on loans held in portfolio (excluding loans sold to Fannie Mae, Freddie Mac, privately securitized, and loans insured by the FHA) shows that the performance of Category 1 and Category 2 loans with an LTV of up to 95 percent had a smaller impact on the portfolios of banks from 2002 to 2011, than loans with an LTVs between 60 and 80 percent. While default rates on high LTV loans were higher, banks held smaller volumes of these loans.



Finally, it is important to recognize and to underscore the role of banks as originators of loans that are sold to third parties, either the agencies or private label securitizers. According to the American Bankers Association, nearly 60 percent of bank originations are sold to 3rd parties.[17] Given the recent history of forced re-purchases and elevated reputational risk combined with higher capital charges under the proposed risk weights, banks may choose to tighten production well within the prescribed parameters or charge more to mitigate the potential costs.

[17] American Bankers Association. Annual ABA Real Estate Lending Survey Report (2012)

4. Proposed Increase in Capital Charge Fails To Consider Other Regulatory Changes

The proposed increase in the capital charge for mortgage loans cannot be viewed in isolation. Beginning with the passage of the SAFE Act in 2008,[18] there has been a wide range of statutory and regulatory changes all designed to enhance the safety of mortgage loans and to protect consumers from the risky practices that are associated with subprime lending. Already in effect are licensing requirements for mortgage originators (SAFE Act), which includes mandatory registration, screening, and training requirements.[19] The Dodd-Frank Act prohibits a creditor from making a mortgage loan without considering the ability of the borrower to repay. The Consumer Financial Protection Bureau is required to promulgate regulations to implement this proposal. These provisions will effectively require that lenders use very high underwriting standards when making a mortgage. The Dodd-Frank Act also requires regulators to implement new rules relating to the securitization of mortgage loans. These regulations will define a "qualified residential mortgage" which will likely become the standard for all new mortgages.[20] These regulations will also require stringent loan underwriting. The CFPB is given greatly enhanced powers to regulate mortgage originators, and the states have new powers to license and regulate mortgage brokers. All of these new mandates will ensure that high underwriting standards are applied to mortgage lending, but will also have the effect of limiting access and increasing the cost of obtaining a mortgage. Adding additional capital requirements for these loans ignores the impact of these laws on mortgage lending, and will result in further raising the cost of mortgage finance without an offsetting increase in safety and soundness.

Even before all of these regulatory mandates take effect, the evidence from the marketplace is quite clear. Unlike the excesses we saw in the last decade, it is very difficult to qualify for a mortgage loan today.[21] Banks and other lenders are demanding far higher credit quality than they did even before the buildup to the bubble. The availability of mortgage capital for creditworthy borrowers is necessary for the restoration of our housing markets. The Federal agencies should not impede economic recovery based on market conditions that no longer exist, and under the new laws and rules described above, are highly unlikely to arise in the future.

In the unlikely event that credit standards for mortgage loans should decline, the regulatory agencies have a whole array of tools at their disposal to stop improper financing of inflated assets. Those tools include the ability to issue institution specific orders, as well as to raise underwriting standards immediately through regulatory issuances.[22] In addition, the Financial Stability Oversight Council, established by the Dodd-Frank Act, could determine at any time that underwriting standards or other practices relating to mortgage lending constitute a systemic risk, and the Council can recommend that the primary Federal regulator of any size bank or other financial company implement enhanced prudential standards to mitigate this risk.[23]

5. Balloon Payments

The proposal contains a blanket prohibition on balloon payment loans in Category 1. For many community based lenders, the use of these products has not been problematic. Congress specifically recognized that balloon loans are useful products in rural and agricultural areas in the Dodd-Frank Act, where an exception was specifically included in the qualified mortgage standard for balloon loans made by lenders in such areas.[24] We urge the capital rule should likewise make a similar

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[18] Secure and Fair Enforcement of Mortgage Licensing Act, Public Law 110-289 at Title V (2008).

[19] The licensing and training requirements apply to mortgage originators that are not employees of insured depository institutions.

[20] The so-called "QRM" proposal was published in the Federal Register on April 29 2012. 76 Fed. Reg. 24090 (April 29, 2011). A final rule is expected either at the end of 2012 or early next year. See, J. Adler and K. Davidson, "Deluge of New Bank Rules Expected After Quiet Summer," American Banker (Sept. 17, 2012)..

[21] The Federal Reserve's survey of senior loan officers reveals that banks tightened underwriting standards every quarter from late 2006 through mid-2010, with very little easing since then. The magnitude and duration of this tightening are unprecedented. Joint Center for Housing Studies Harvard University, *The State of the Nation's Housing* 2012 at 19.

[22] See, e.g. Interagency Guidance on Nontraditional Mortgage Product Risks, and Addendum to Credit Risk Management Guidance for Home Equity Lending , October 5, 2006..

[23] Section 120 of DFA.

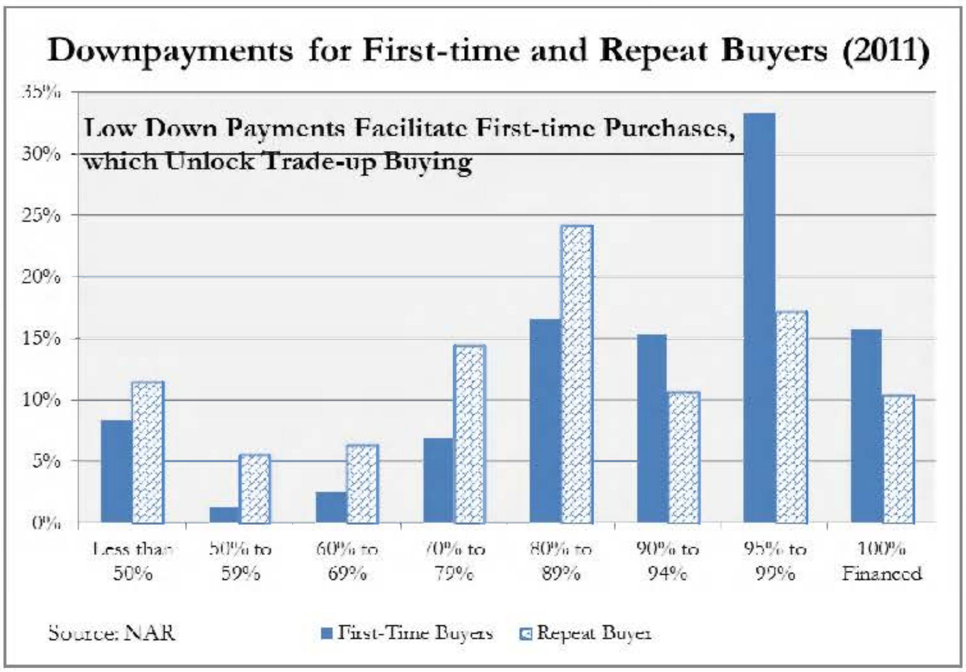
[24] Section 1412 of the Dodd-Frank Act, adding section 129C(b)(2)(E) to the Truth-in-Lending Act.

exception for prudently underwritten balloon loans made in rural and agricultural areas, and allow such loans to be included as Category 1 mortgages.

6. Proposed Rule Will Have a Disproportionate Negative Impact on First-Time Homebuyers and Low- and Moderate-Income Families

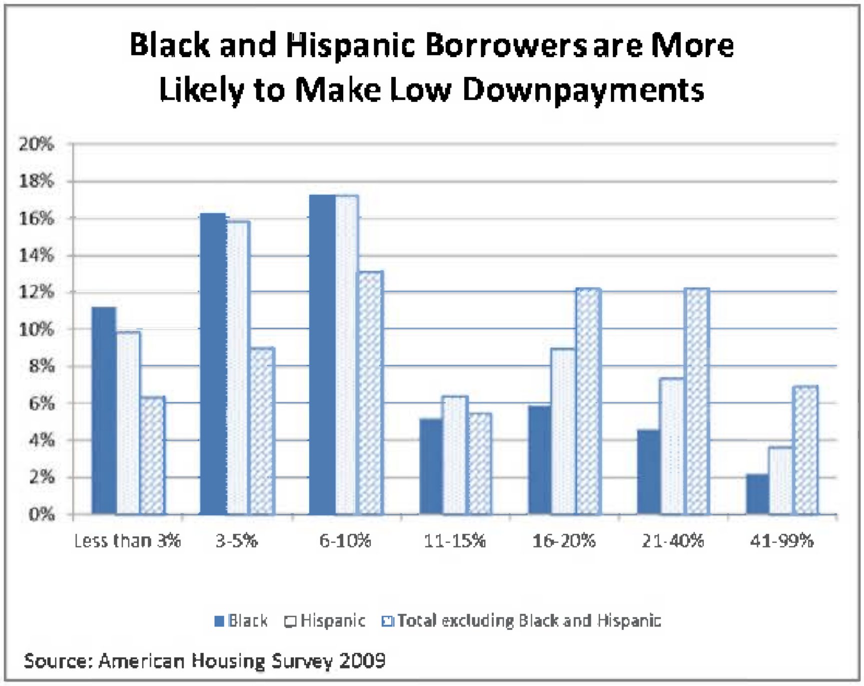
Increasing the capital charge, and thus cost and availability of mortgage loans with an LTV in excess of 80 percent, will have a disproportionately adverse impact on first-time homebuyers, minorities and other underserved populations. These groups have the least ability to accumulate the large down payments necessary to meet the 80 percent LTV threshold. As a result, many creditworthy consumers will be denied access to prudently underwritten conventional mortgage loans that they would have qualified for prior to the housing bubble.[25]

As the chart below demonstrates, in 2011 roughly 80 percent of all first-time home buyers put less than 20 percent down, and nearly 50 percent of first-time home purchasers put 5 percent or less down.

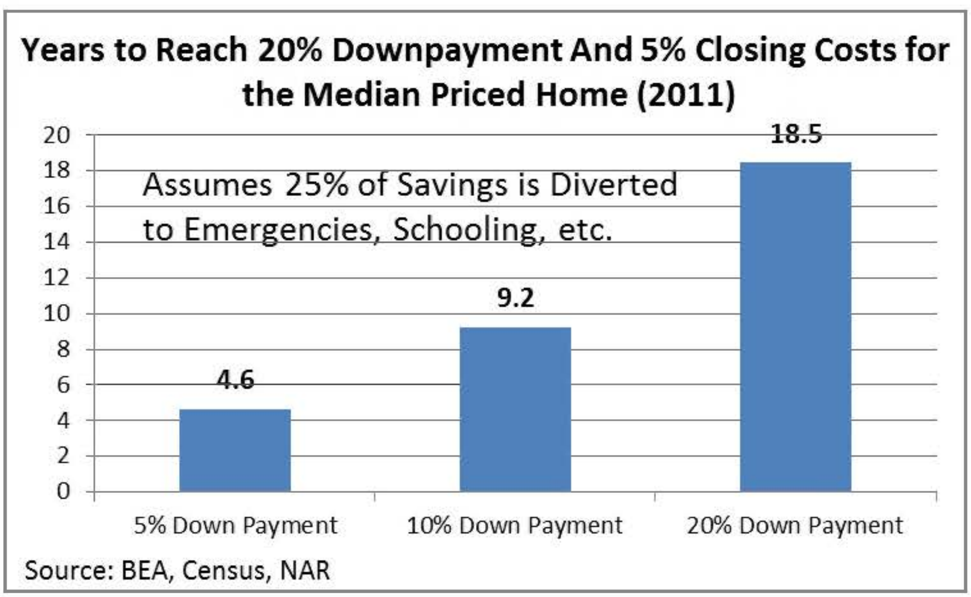


[25] Prior to the deterioration in underwriting standards, approximately 40 percent of all home mortgages purchased by Fannie Mae and Freddie Mac had LTV ratios in excess of 80 percent. Source: FHFA Data for mortgage purchases in 1999 and 2000

Minority homebuyers will be especially burdened. As the chart below indicates, nearly 45 percent of African-American buyers and 43 percent of Hispanic buyers took out mortgages that were above 90 percent LTV in 2009.



While minorities as a group will be hardest hit, all American families that have not built up equity in a first home will find it hard to save for a 20 percent down payment. Based on NAR estimates, assuming that 100% of family savings are dedicated towards a downpayment and closing costs, it would take nearly two decades for a family with a median household income to save enough for a 20 percent downpayment for a $150,000 home (a value lower than the current median). Even a 10 percent downpayment would take a family more than nine years to save.



While the capital proposal will make it more difficult to finance the purchase of a starter home, all segments of the housing market will be adversely affected. The ability of families to move up to larger homes usually depends upon the sale of their first home. Reducing access to mortgage capital and increasing the cost of financing for first-time home buyers reduces the demand for starter homes, thus depressing the demand for larger homes with more space. The result is that the entire housing market is affected. The damage is not confined to a particular segment.

7. Residential Mortgage Modifications

Under the proposal, loans modified under the Home Affordable Mortgage Program (HAMP) will continue to receive the same risk weight as at the time of the loan's origination. However, other residential mortgages that are modified would be reclassified as Category 1 or Category 2 loans, and a new LTV would be computed. Because of the decline in housing values, the modified loan would probably have a high LTV, and due to the special circumstances involved in a loan modification (such as repayment terms in excess of 30 years), could also become Category 2 loans. The result will be to impose significant capital penalties for loan modifications outside of the HAMP program. We believe that this differential treatment would have an unfair and serious adverse impact on families and our housing recovery, and that loan modifications should be encouraged, not disadvantaged, by Government regulations.

D. Recommendation

For the reasons discussed above, we recommend that the proposed regulation be modified so that it more accurately correlates the risk presented by a Category 1 loan and the assigned risk weight. We believe that a valid statistical analysis based on the current loan underwriting practices, and taking into account all of the statutory and regulatory changes, will demonstrate that a Category 1 mortgage loan should be assigned a significantly lower risk weight than proposed, and certainly not higher than the current risk weight for loans with an LTV of up to 95 percent. We also believe that credit enhancements, such as mortgage insurance provided by financially responsible insurance companies, should be able to reduce calculation of the LTV of a mortgage for capital purposes. This will enable creditworthy borrowers to use credit enhancements in lieu of a large down payment in order to obtain mortgage credit at reasonable prices. Finally, we recommend that, as similar to the treatment afforded in the Dodd-Frank Act's provisions on qualified mortgages, Category 1 loans include balloon loans that are made by financial institutions that predominately serve rural and underserved areas.

II. Mortgage Servicing Rights

A. Current Treatment

Mortgage servicing rights (MSRs) are contractual rights a bank has to service mortgages that the bank does not hold. These rights may arise when a bank sells a mortgage but retains the right to perform the servicing of that loan, or when an institution purchases the right to service mortgages held by another. The value of the asset is based on the amount of fees expected to be generated for performing the servicing function.

Under the current risk based capital rules, the value of MSRs is subject to a haircut of 10 percent, so that for regulatory capital purposes they are valued at 90 percent of fair market value. In addition, the total amount of MSRs, credit card servicing rights, and credit-enhancing interest-only strip securities cannot, in the aggregate, exceed 100 percent of tier 1 capital. Any excess must be deducted from tier 1 capital. MSRs that are not deducted from capital are given a risk weight of 100 percent

B. Proposed Treatment

Under the NPR accompanying the Standardized Approach proposal,[26] MSRs would be limited to 10 percent of common equity. In addition, the aggregate amount of MSRs, deferred tax assets, and certain investments in the common stock of other financial institutions would be limited to 15 percent of common equity capital requirement. MSRs that exceed these limits are deducted in full from regulatory capital. To the extent that MSRs are not required to be deducted, they would be risk weighted at 250 percent.

[26] Regulatory Capital Rules: Regulatory Capital, Implementation of Basel III, Minimum Regulatory Capital Ratios, Capital Adequacy, Transition Provisions, and Prompt Corrective Action

C. <u>Discussion</u>

Under the proposed rule, it would be prohibitive for most banking organizations to retain or acquire any significant amount of mortgage servicing rights. However, all of the Federal banking agencies recognize that MSRs have value and loss absorbing capacity.[27] Smaller and community banks often do not have the staff, computer systems or other technical requirements to efficiently service a large number of mortgage loans. The recognition of MSRs as an asset allows community banks to participate actively in mortgage lending, knowing that they can sell the accompanying servicing rights to an institution that has the necessary capacity to be a servicer. However, if the rule is implemented as proposed, banking institutions, large and small, will likely have to withdraw from the market for servicing, and the ability of smaller banks to sell this asset will be harmed.

Likewise, some community banks may wish to perform the servicing function for loans they originate, but due to economies of scale, will need to purchase servicing rights from other originators in order to develop the volume of servicing necessary to build and maintain the required systems. However, under the capital proposal, the acquisition of the additional MSRs will be prohibitive, and, therefore, these institutions may not be able to engage in this activity.

The recognition of MSRs as an asset for regulatory capital purposes also fosters securitization transactions, which typically bundle large numbers of geographically dispersed loans into securitization trusts that are not equipped to service the loans. However, banking organizations that currently compete for the right to service these loans will withdraw from this activity under the proposed regulation.

Another adverse consequence is that banking organizations currently holding MSRs will be forced by the capital regulation to sell these assets to non-banking companies. This will result in a loss of a valuable asset for the banking industry, lower the value of the MSRs retained by some banking companies, and drive the bulk of mortgage servicing to businesses with less regulatory oversight.

We are aware that MSRs present risks. The risks include an unexpectedly large number of prepayments, since when a loan is paid off the associated servicing disappears. Other risks are default and foreclosure; both of which increase the cost of servicing. During the financial crisis, the value of MSRs declined perceptibly due to the large number of defaults, foreclosures, and refinancing transactions arising from the financial crisis. However, we believe that it is not appropriate for the Federal agencies to design a capital framework based on the assumption that the poor underwriting that led to the financial crisis will continue. As noted previously in this letter, due to both capital market realities and the recently adopted or pending statutory and regulatory changes, the quality of mortgages that are being originated now and in the future will be very high. The quality and value of MSRs should be viewed in this light, and not based on a presumed return to irresponsible lending.

D. <u>Recommendation</u>

During the 1990s, the Federal agencies loosened capital restrictions on MSRs because the regulatory experience demonstrated that in a normal environment, these assets added value to a bank's financial condition.[28] At that time, the agencies expressed the view that the requirement to haircut this asset by 10 percent, and determine its fair market value on a quarterly basis, would provide sufficient safety to enable banks to hold this asset in an amount of up to 100 percent of tier 1 capital. We recommend that the proposed rule be modified by deleting the restriction on the amount of MSRs that can be

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[27] See, e.g., Testimony of FDIC Chair Sheila Bair, Hearing on Implementing the Dodd-Frank Act, Before the Senate Comm. On Banking, Housing and Urban Affairs, 111th Cong. 2d Sess. 67 (2010)(While the value of mortgage servicing rights can be volatile, they clearly have value.); Testimony of Federal Reserve Board Tarullo, Hearing Before the Subcommittee on Security and International Trade of the Senate Comm. On Banking, Housing and Urban Affairs, 111th Cong. 2d Sess. 16 (July 20, 2011)(Mortgage servicing rights, again, are not the same as an asset already on the balance sheet, but they are an expected stream of earning which have performed well in the past.).

[28] See, e.g. 63 Fed. Reg. 42667 (Aug. 10, 1998), increasing the limit on MSRs from 50 percent to 100 percent of tier 1 capital. The banking agencies explained that increasing the limit on these assets is appropriate in light of the stringent valuation and impairment standards that are applicable to MSRs and that the volume of these assets that is traded regularly in the market has greatly increased making market-based data more readily available.

held, and instead mandating that in order to avoid a quantitative limit, the loans associated with the MSRs must meet minimum requirements relating to the quality of the loan, along the lines of the "qualified mortgage" concept specified in the Dodd-Frank Act.

III. Mortgage-Backed Securities

A. Current Treatment

Mortgage-backed securities (MBS) that are issued or backed by an agency of the United States, such as GNMA, are given a 0 risk weight. MBS issued by a Government-Sponsored Entity, such as Fannie Mae or Freddie Mac, are assigned a 20 percent risk weight. Private label MBS are assigned a risk weight based on the credit rating of the position, as follows:

Long-term rating category	**Examples**	**Risk weight (In percent)**
Highest or second highest investment grade	AAA, AA	20
Third highest investment grade	A	50
Lowest investment grade	BBB	100
One category below investment grade	BB	200
Short-term rating	**Examples**	**Risk weight (In percent)**
Highest investment grade	A–1, P–1	20
Second highest investment grade	A–2, P–2	50
Lowest investment grade	A–3, P–3	100

B. Proposed Treatment

The proposal does not change the treatment of MBS that is issued or backed by a U.S. agency (0 percent risk weight) or MBS that is issued or backed by Fannie Mae or Freddie Mac (20 percent risk weight). However, the proposal makes significant changes in the treatment of private label MBS.

For private label securities, the proposal does away with reliance on credit ratings,[29] and instead will require the investing bank to undertake its own due diligence of the credit risks involved, and demonstrate to the bank's examiner a comprehensive understanding of the structure and risks of the security. The due diligence must include an analysis of the features of the securitization that could materially affect performance, including the cash flow waterfall, triggers, credit enhancements, and the specific definitions of default used in the securitization. The bank must also consider relevant information about the performance of the underlying securities, market data, price volatility, trading volume, liquidity support, percentage of loans that are 30, 60 and 90 days past due, loans in foreclosure, overall default rates, occupancy data, average LTV of the underlying loans, average credit scores of the borrowers, the extent of the geographic diversification of the loans and size, and depth and concentration of the market for the securitization including bid-ask spreads. The bank's analysis must be conducted and documented prior to the purchase of the instrument. If the bank cannot demonstrate such a comprehensive understanding, it would be required to risk weight the exposure at 1,250 percent.

Based on the bank's analysis, the appropriate risk weight for the security would be determined using one of two prescribed models in the regulation. One model, the so-called "gross up" approach, requires a bank to hold capital against the security held by the bank, as well as all of the more senior positions that are supported by that security. The second

[29] Under section 939A of the Dodd-Frank Act, the regulatory agencies are required to end the use of credit ratings for regulatory purposes.

model, the "simplified supervisory formula approach," requires a bank to input various parameters[30] and rely on a supervisor provided formula for determining the capital charge.

With respect to banks selling mortgages into a securitization pool, a proposal accompanying this NPR[31] prohibits the selling bank to deduct from tier 1 regulatory capital any non-cash gain on sale that would be recognized under generally accepted accounting principles, and apply a risk weight of 1,250 percent to any credit enhancing interest only securities generated by the securitization.

C. Discussion

We agree with the proposal that the risk weight for mortgage backed securities issued or guaranteed by a U.S. agency and Government-Sponsored Entities should not be changed. However, we are concerned that the proposal will have a harsh impact on the availability of non-conforming loans. These loans are not eligible for purchase by the Government-Sponsored Entities and thus are securitized in the private label market. In many areas, the real estate market is dependent upon non-conforming loans, simply because the mortgages necessary to purchase homes in these locations exceeds the conforming loan limit. Many of these mortgages can be funded through deposits, Federal Home Loan Bank advances, and other sources. However, a healthy market cannot be maintained without the ability to place a large percentage of these mortgages into a private label securitization.

The proposal inhibits demand for private label securitization by making it very difficult, if not impossible, for small and community banks to purchase private label MBS. These institutions simply do not have the capacity to undertake the extensive analysis demanded by the proposal, and thus are likely to be frozen out of the market for these securities. The result will prevent these banks from acquiring higher yielding securities that will be backed by the stringently underwritten mortgages that are now being made. As noted previously, these underwriting standards will continue to be mandated under the Dodd-Frank Act and other regulatory changes soon to be issued.

Besides harming the community and smaller banks, the proposal will have a deleterious impact on the market for private label MBS by reducing demand for these securities by effectively eliminating a large number of prospective purchasers. As a consequence, the interest rates and other costs for these loans will increase, or the amount of funds available for non-conforming loans will decline, or both. The deduction from capital of non-cash gains will also result in increased costs for mortgage loans, since the securitization process will essentially become more expensive for the selling bank.

D. Recommendation

We understand that under the Dodd-Frank Act the banking agencies can no longer link the risk weight for securities with the credit rating of those instruments. However, expecting small and community banks to engage in a sophisticated exercise to self-rate these products is not realistic and will have broader negative consequences for the housing markets. We, therefore, recommend that for small and community banks the requirement to engage in the extensive due diligence be waived and that a risk weight of 20 percent be assigned to private label MBS provided that all of the loans meet minimum underwriting standards, for example meeting the underwriting criteria required by Fannie Mae or Freddie Mac or those loans that meet the definition of QM.[32] Further, we believe that the purchasing bank should be able to rely on a representation by the securitizer that all the loans meet the specified criteria, and that the due diligence obligation of the purchasing bank be limited to a sampling of the loans. A small or community bank should be able to rely on an independent third party to conduct this sample, provided that the third party is not compensated by the issuer. We believe that there are many companies that have considerable expertise in conducting such due diligence, and in addition to prohibiting compensation by

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[30] The inputs supplied by the bank include as the percent of the underlying loans that are past due, subject to bankruptcy, in the process of foreclosure, held as real estate owned, or is in default, as well as the securitization attachment point and detachment point, and a supervisory calibration parameter.
[31] See NPR on "Regulatory Capital Rules: Regulatory Capital, Implementation of Basel III, Minimum Regulatory Capital Ratios, Capital Adequacy, Transition Provisions, and Prompt Corrective Action."
[32] In light of the fact that GSE mortgage-backed securities are assigned a risk weight of 20 percent, it would seem logical that private label securities that are collateralized by loans meeting the same underwriting standards should also have a 20 percent risk weight.

the issuers, other potential conflicts of interest could be avoided by appropriate regulations designed to ensure the integrity of the process.

Commercial Mortgage Lending

I. Commercial Real Estate Loans

A. Current Treatment

Commercial real estate loans are generally risk weighted at 100 percent.[33]

B. Proposed Treatment

The proposal assigns a 150 percent risk weight to "High Volatility Commercial Real Estate" (HVCRE) exposures. An HVCRE exposure is defined as "a credit facility that finances or has financed the acquisition, development, or construction (ADC) of real property, unless the facility finances:

- One to four family residential properties; or
- Commercial real estate projects in which:
- The LTV ratio is no greater than the maximum LTV ratio set by the bank's regulator;
- The borrower has 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 appraised completed value of the project; and
- The borrower contributed the required amount of capital before the banking organization advances funds, and the capital contributed by the borrower, or internally generated by the project, is contractually required to remain in the project throughout the life of the project.

C. Discussion

The proposal increases the capital charge for ADC loans for multi-family residential properties, and other commercial real estate projects, by 50 percent unless various conditions are met, including a significant capital contribution made by the developer and the loan's meeting supervisory LTV limits. The LTV limits vary by the purpose of the loan, from 65 percent for loans secured by raw land to 85 percent for loans backed by already improved properties.[34] Thus, depending upon the project, a developer must provide a "down payment" of between 15 percent and 35 percent of the loan amount in order to meet the LTV test. The proposed rule would also require the developer to contribute at least 15 percent of the appraised completed value of the project. It is not clear how this requirement would be applied if the loan was for the purpose of finishing a phase of the project, rather than completing the entire development. In any case, we believe that most developers would not be able to comply with these pre-requisites and therefore HVCRE loans are likely to become costlier under the proposal.

Many community banks rely on commercial real estate lending for a significant source of their income. Increasing the capital charge for HVCRE loans will make community banks less competitive in this market, and will create a significant burden for these institutions. We understand that the commercial real estate market suffered a significant downturn, along with the rest of the economy, as a result of the financial crisis. Many institutions suffered losses on their commercial loan portfolio as a result. However, all indications are that the commercial real estate market is recovering, loan underwriting standards are more stringent, and the quality and performance of commercial real estate loans is likely to improve. Imposing a higher capital charge on these loans is not consistent with the risk that new loans will present, and will have an adverse impact on the health and capital position of banks that already have significant exposures on their books. To the extent that the

[33] By statute, certain commercial real estate loans are assigned a 50 percent risk weight. These include loans for the construction of residential homes if the homes have been pre-sold and other conditions have been met. Certain loans for multi-family construction projects are also assigned a 50 percent risk weight if statutory conditions are satisfied.
[34] See, 12 CFR parts 34, subpart D, 208 subpart C, and 365.

regulators have any concerns that weak underwriting practices will return to the HVCRE market, they have numerous regulatory and supervisory tools at their disposal to rein in such practices.

We are also concerned that the proposed treatment of past due HVCRE will be counterproductive. Currently a commercial real estate loan that is past due will be classified as non-performing, and the bank will have to adjust its allowance for loan and leases losses (ALLL) to reflect the amount of the loan that is unlikely to be repaid. However, the bank will be able to continue to apply the same risk weight to the value of the loan that has not been written off. Under current rules that would be 100 percent. Modified and restructured commercial real estate loans are treated similarly, provided that the modified loans are likely to be repaid according to their terms.

Under the proposal, past due HVCRE loans would be risk weighted at 150 percent, even after the loan has been written down and the ALLL has been adjusted. As explained above, we believe that the risk weight for HVCRE loans should remain at 100 percent. Likewise, we believe that after a past due HVCRE loan has been written down, and the bank's ALLL has been adjusted, the remaining value of the loan should also be risk weighted at 100 percent. Any other approach would be punitive towards the bank, since the loan write down will result in a decrease in capital, and increasing the risk weight of the remaining amount of the loan (that the bank is expected to recover) would also result in decreasing the bank's capital.

It is not clear from the proposal if the 150 percent risk weight is also intended to apply to HVCRE loans that are modified or restructured. If the risk weight for performing HVCRE loans remains at 100 percent, applying a higher risk weight for restructured or modified loans that have been determined likely to be repaid is again punitive to the bank and would have the effect of discouraging lenders from working with troubled borrowers.

D. Recommendation

NAR believes that the proposed definition of HVCRE is too broad, and the exception from HVCRE treatment is far too narrow. The proposed treatment of HVCRE does not recognize many current practices that reduce the risk of an ADC loan. For example, some borrowers provide land rather than cash for a CRE loan. These ADC loans would be subject to a 150 percent risk weight under the Standardized Approach NPR, even though the loan is less risky due to the borrower's investment in the property. Similarly, the proposed rule does not recognize pre-leasing tenant agreements, even though such agreements guarantee income for the property and therefore reduce the risk of loss. We therefore urge the agencies to continue to apply a 100 percent risk weight to HVCRE loans. Likewise, the agencies should not impose a punitive risk weight to past due loans that have been written down and are valued at the amount the bank is expected to recover, or to HVCRE loans that have been modified or restructured into loans that the borrower is expected to repay.

Conclusion

The proposed regulations include many important improvements to the current regulatory capital rules, including a greater emphasis on equity capital. However, the proposal also would impose harsh new capital requirements on residential mortgages, whether held in portfolio or sold into a private label securitization. The proposal would also increase the costs of funding certain commercial real estate projects. As a result, the proposal has the potential to harm home purchasers, particularly first-time home buyers, minorities, and other disadvantaged groups. We believe that there is no question that mortgage costs would increase, and access would be limited, for the vast number of qualified and credit-worthy consumers unable to afford a 20 percent down payment on top of closing costs and other fees. Further, since the sale of "starter" homes is key to the sale of homes for growing families, the adverse consequences would be transmitted throughout the housing market. In turn, a slowing in the housing market will have an adverse impact throughout the economy, as we saw demonstrated during the financial crisis that began in 2007.

As we detailed in our letter, the large increases in risk weights proposed for mortgage loans with an LTV in excess of 80 percent, as well as the harsh treatment of mortgage servicing rights, private label mortgage backed securities, commercial real estate lending, and the other items discussed above are not warranted by the data. New laws, regulations, and market conditions make certain that non-traditional lending practices and other abuses that occurred during the housing bubble are gone. Therefore, it is critically important that the agencies analyze this proposal in light of the performance of traditionally underwritten mortgage products, and not based on the performance of the very risky mortgages that were made during the housing mania.

We urge that the agencies treat the current proposals as "advanced notices of proposed rulemaking" and then conduct the necessary studies, hold hearings in which the public and affected parties may make presentations, and fully consider the evidence and adverse economic consequences that could well ensue by dramatically increasing the cost of mortgage lending. Further, we believe that the agencies must take into account the other laws and regulations that impact mortgage lending. Capital regulations should not be promulgated in a vacuum, but must consider the entire regulatory and market framework affecting the industry. Finally, it is important that the policy objectives of the Treasury and the Federal Reserve Board relating to economic recovery, such as lowering mortgage rates and encouraging loan modifications, should not be impeded by capital regulations that are not fully aired and debated before they are issued in final form.

We would be pleased to discuss these issues in more detail at your convenience. If you have any questions, please contact Charlie Dawson, our Policy Representative for Financial Services, at cdawson@realtors.org or 202.383.7522.

Sincerely,

Maurice "Moe" Veissi
2012 President, National Association of REALTORS®